ECONOMIC AND SOCIAL COMMISSION FOR ASIA AND THE PACIFIC

ISSUES AND EXPERIENCES IN TAX SYSTEM REFORMS IN SELECTED COUNTRIES OF THE ESCAP REGION

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PREFACE

This volume contains the revised versions of six case-studies prepared by consultants from six developing countries of the ESCAP region on their experience in tax reforms and an overview paper which summarizes the principal issues and findings. The studies address important dimensions of tax reforms: the tax base, the rate structures, and the administration and enforcement of major tax instruments. The efficiency of reforms is evaluated in the light of the objectives sought to be achieved. A major issue addressed is the impact of taxation on equity and the alleviation of poverty in the region.

The studies tend to agree that tax policy measures *per se* have little to contribute to alleviation of poverty or even to promote equitable distribution of income. These objectives are better promoted through public expenditure policies. The objective of tax policies should be simplified to raising sufficient revenue for the necessary public expenditure in a manner that does not distort the incentive structure and the pattern of resource allocation in the economy.

The highly progressive rates and the tax rate and base differentiations in the past are found to have had adverse effects on incentives and resource allocation on numerous considerations. Besides, these affected revenue productivity of taxes and their effective administration and implementation. Reform measures have, therefore, been directed in all the countries towards a lowering of average rates, simplification of structure, removal of discriminatory incentives and improvement of the legal and administrative infrastructure for a better enforcement of taxes. In relation to the equity objective, the emphasis has been on horizontal equity that seeks equal treatment of the equals through effective extension of taxation to those who hitherto escaped taxation, rather than on vertical equity through highly differentiated bases and progressive rates of taxation.

The studies in the volume contain a rich body of information on tax reform experiences. The volume should be of great use to researchers and policy makers dealing with tax reforms.

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PART ONE:
AN OVERVIEW OF ISSUES AND EXPERIENCES

I. RATIONALE FOR TAX REFORMS

Since the initiation of development efforts in countries of the ESCAP region, the accent of public policy has been on the promotion of rapid economic growth, more equitable distribution of income and the fastest possible eradication of mass poverty. Official pronouncements and plan documents since the 1950s will bear testimony to such expressions of intent. The degree of emphasis placed on these objectives and the means adopted to achieve them have varied over time and among countries. Most countries have used fiscal policy measures, among many other policies and measures pursued, to achieve these objectives.

Fiscal policy, with taxation at its core, was looked upon as way of promoting growth and development.[1] Taxes were to be geared to raising revenue in excess of current government expenditures to generate public savings to finance infrastructural and other developmental expenditure. Governments have achieved varying degrees of success in generating such surpluses to invest, though the size of the surpluses has not always been adequate. The financing of development has therefore depended in many cases on borrowings or on foreign aid.

The inability to raise enough tax revenue was partly inherent in the existing economic structure in which the tax measures could not be extended to majority of the population or to the major proportion of incomes generated in the economy. The low income-tax coverage of the population because of the low average level of income and unorganized nature of most economic activities were important factors in this regard.

That necessitated excessive dependence on commodity based taxes, of which commodities passing through foreign trade became obvious and easy targets. Commodities produced and sold domestically were also subjected to taxes in the form of excise and sales levies. Apart from the revenue goal, the commodity taxes were often intended also to serve other objectives. Differentiated rates, exemptions, refunds and drawbacks were built into tax structures to promote equity, or to attain other objectives. These resulted in multiplicity of tax bases and rates to make the systems complicated indeed.

The cascading effects of taxes, the same tax or the different commodity taxes impinging on the same commodity at different stages of production, sale or distribution emerged as one form of these complications. The totality of their impact on resource allocation, growth and equity became uncertain at best; their administration and compliance lost the virtue of simplicity; and their revenue productivity became unresponsive to changes in income levels particularly where specific rather than ad valorem tax rates were set.

Commodity taxes have traditionally been regarded as distortive, violating the neutrality principle of taxation. Governments sought to use them deliberately to influence resource

[1] Capacity to tax in a major way defines the limits of the capacity to spend.

allocations to redress the distortions perceived to exist in their economies. The discretionary judgements made in the process have however often aggravated existing distortions or created new and more undesirable ones.

The income tax has been traditionally regarded as neutral, and elastic and certain in terms of revenue productivity. Income taxation is also best suited to serving the equity objective in terms of sharing the burden of taxation and redistribution of income. The neutral feature of both the individual income and the company income taxes (the two components of the tax) has long been in doubt. While the corporate tax could discourage investment by raising the cost of capital, the burden of the tax could as well be shifted, as in the case of commodity taxes. The personal income tax can also discourage the incentive to work, save and invest, particularly if the rates become too progressive on equity and distributional considerations.

Allowances and incentive provisions have therefore been built into the income and corporate tax structures to encourage or at least not to discourage savings and investment activities. That however has often been found to erode their revenue potential and apparent progressivity and equity. The income tax is a more difficult tax to administer. The scope and potential for avoidance and evasion of taxes always exist. In the developing countries, apart from the difficulties posed by low incomes and unorganized nature of economic activities, tax avoidance and evasion have been major problems for a greater reliance on the income tax.

Owing to the factors mentioned above, the tax system in many developing countries tended to become less elastic to changes in income, less equitable and more distortive than intended. The levels of budget deficits and borrowing and/or aid requirements became unsustainable. A lowering of expenditure targets or higher revenue mobilization or both, to reduce budget deficits thus became a major target of structural adjustment programmes in the short term. Higher revenue productivity to finance expenditures and reduce dependence on foreign aid and borrowings is however likely to remain a long term need in developing countries. The rising demand for more and better public services would require governments to spend more rather than less in the future and tax system should be able to raise the necessary revenue. The revenue must be raised in a manner that causes the least distortions and the least disincentives in the market driven economy.

The tax reform "movement" spread widely in both developing and developed countries since the beginning of the 1980s. The underlying objectives and motivation for reform reflected the various above mentioned considerations. Some countries had to undertake tax reforms in the face of persistent increases in fiscal deficits causing severe macroeconomic and balance of payment difficulties, and therefore, enhancing revenue productivity of taxes became the major focus of reforms. A common motivation for tax reforms in developing countries however has been the realization that the prevailing tax systems are complex, inelastic, inefficient and inequitable.[2]

Some of the basic directions in which recent tax reforms have proceeded and their underlying rationale can be briefly summarized as follows:

(i) Systemic reforms: Successful tax reforms involve systemic improvement in the tax structure encompassing the bases and rates of taxation, and tax

[2] J.K. Shirazi and A. Shah (eds), *Tax Policy in Developing Countries* (Washington, DC, The World Bank, 1991).

administration including the assessment and enforcement capabilities. Reforms to simplify the tax structure is an important part of systemic reforms. It is also important to simplify the forms and procedures, strengthen enforcement machinery and improve the information system. Complicated tax structure and poor quality of information enhance administration and compliance costs. Enforcement of tax by search and seizure operations is arbitrary, causes harassment and provides scope for corruption. An organized and scientifically managed (computerized) information system can do away with these undesirable features of enforcement practices, enhance voluntary compliance and improve efficiency of tax collection.

(ii) Broadening the tax base: Broadening the tax base imparts greater economic neutrality in the tax system in two ways. First, the broader the tax base, the lower is the discrimination between different forms of income or consumption. Second, when the tax base is broader, a given amount of revenue can be raised at lower tax rates and thus minimizes adverse economic effects. In addition, broader tax base ensures horizontal equity better.

In the case of taxes on individual incomes, broadening of the base requires extending the tax to the incomes generated in the informal sectors and hard-to-tax groups. This calls for keeping the exemption limit at relatively low levels and deductions at the minimum. Similarly, in the case of company taxes, this calls for doing away with many tax preferences. With regard to consumption taxes, broadening of the tax base is achieved by minimum exemptions and extending the tax to retail stages. The introduction of retail stage value added taxes has been a major innovation in this sphere.

(iii) Low and uniform tax rate: As economic efficiency consideration gained ascendency in reform objectives, reducing adverse effects on resource allocation became important in the design of tax rates. In the case of income taxes, the experience with confiscatory tax rates in some countries demonstrated their ineffectiveness in achieving the desired state of income redistribution due to both adverse effects on incentives and widespread evasion and avoidance of taxes. The demonstration of the possibility of declining tax yield at very high tax rates popularly known as the "Laffer curve" phenomenon underlined the need to have "reasonable" and less differentiated tax rates with better enforcement of the taxes in order to raise revenue productivity of the tax system. Vigorous pursuit of unequal treatment of unequals in such cases resulted in unequal treatment of equals.

In the case of consumption taxes too, low and less differentiated tax rates were needed to minimize both distortionary effects and tax evasion. Optimal tax theory has demonstrated that neutrality in tax rates is achieved only when the tax rates are designed to achieve equi-proportionate reduction in demand, which must necessarily vary inversely with the price elasticity of demand for commodities. However, the administration and information costs of designing such a structure are prohibitive and hence, practical approaches to tax reform have generally preferred uniform rate structure.[3] Uniform rate structure has also been justified on the ground that it avoids the need to make rate differentiation at the behest of special interest groups.

[3] R.A. Musgrave, "Tax reform in developing countries" in David Newbery and Nicholas Stern (eds), *The Theory of Taxation for Developing Countries* (Oxford University Press, 1987).

(iv) Simplicity: In many developing countries, taxes are designed not in conformity with conditions prevailing in them. Therefore, a common thread in tax reforms has been to make the tax structure simple and transparent. In most of the developing countries, the pursuit of several non-revenue objectives through the instrument of tax policy like interregional and interpersonal redistribution, giving incentives to savings, investment and employment and fulfilment of various social objectives have complicated the tax structure. Most reform approaches take revenue raising to be the single most important objectives of tax policy and therefore, emphasize simplicity and transparency. A simple tax system involves minimum administration and compliance costs.

(v) Tariffs are primarily a "protective device": A high degree of reliance on import duties as a source of revenue is a feature observed in many developing countries. Given the ease of collections and a high dependence of developing countries on imports, it is not surprising that often, tariffs are used more as a source of revenue than a protective instrument. This has often resulted in unintended patterns of effective protection and caused distortions in production structures. Tax reforms have attempted to restore the protective role of tariffs. In doing so, it is necessary to ensure that potential revenue loss from tariff reduction is made up through larger revenues from internal trade taxes in order to avoid budgetary difficulties.[4] For this reason, the introduction of a consumption type value added taxes (VAT) has been an important component of tax reforms in a number of developing countries.[5]

(vi) Tax equity, income redistribution and poverty alleviation: Traditionally, tax policy was taken to be a major instrument to achieve redistribution of income. However, effectiveness of sharply progressive taxes in achieving income redistribution in developing countries has not been impressive. The wide-ranging exemptions, deductions and credits given for various purposes and the existence of a large informal sector and powerful "hard-to-tax" groups, opened large avenues for evasion and avoidance of taxes. Consequently, it is being increasingly perceived that vertical equity in tax policy is an elusive goal. The progressive income taxes apply effectively only to a narrow group of persons earning mainly salary incomes. Therefore, emphasis has shifted to horizontal equity. This is achieved not by having confiscatory rates but by low and less differentiated rates and through improved administration and enforcement of the tax.

Experience in several developing countries has shown that tax policy as a redistributive instrument has not been very effective. It is not very meaningful to talk in terms of redistribution when only a very small percentage (often, less than 1 per cent) of the population actually pays the personal income tax, and many among them simply evade or avoid tax payment. During the last decade, the emphasis has thus changed from vertical equity to horizontal equity. It was realized that the objective of equity would be better served if the emphasis is shifted from

[4] P. Mitra, "The coordinated reform of tariffs and indirect taxes" in Javad K. Shirazi and Anwar Shah (eds), *Tax Policy in Developing Countries* (Washington, DC, The World Bank, 1991).

[5] A. Bagchi, "Tax reform in developing countries — Agenda for the 1990s", *Asian Development Review*, vol. 9, No. 2 (1991); and M.G. Rao, "Reform of indirect taxes in developing countries: Selected issues", *Asian Development Review*, vol. 10, No. 2 (1992).

reducing the incomes of the rich to increasing the incomes of the poor – a change from the "levelling down" concept of redistribution.[6] At the same time, the development experience of many countries has shown that living conditions of the poor can be improved better by having tax policy to accelerate growth rather than persisting with highly redistributive tax systems.[7]

Studies have shown that the optimal policy design to alleviate poverty is a combination of direct and indirect approaches.[8, 9] The direct approach consists of the public provision of minimum needs like education, health, housing, nutritional supplements, and transfer payments which directly enhance the consumption of the poor. The indirect approach to poverty alleviation consists of the efficient use of existing resources to accelerate economic growth. This "pull up" or "trickle down" strategy is found to be more successful when supplemented with policies to direct the benefits of growth to the poor by giving them access to capital (land reforms and access to credit) and by allocating resources in activities which have higher trickle down effect.

In both direct and indirect approaches, the role of public expenditure policy is critical. The public expenditure policy helps poverty alleviation in both direct and indirect ways. First, alleviation of poverty crucially and directly depends on the volume of redistributive expenditures undertaken by the government and targeting it to benefit the poor. Second, indirectly the complimentary effects of public expenditure policies in enhancing private investment, employment and incomes help alleviate poverty. In particular, stepping up public investment in irrigation, agricultural research and extension and in social development has been found to be effective poverty alleviation strategies.

Tax policy, on the other hand, is designed mainly to raise resources required to finance poverty alleviation expenditures in non-inflationary ways. This, however, has to be achieved with the least adverse effects on the efficiency in resource allocation, as tax induced distortions in relative prices and cost increases can adversely affect economic growth and thereby reduce the benefits flowing to the poor. Hence, the emphasis on economic neutrality and revenue productivity as primary objectives of tax policy even for alleviating poverty.

While it is clear that much of the distributional concerns will have to be dealt with by government expenditures, it is important that the required revenues are raised through taxes with some degree of progression. Typically, the distribution of income in developing countries is highly skewed with a large proportion of people in the

[6] M. Gillis, "Comprehensive tax reform: The Indonesian experience, 1981-1988" in Malcolm Gillis (ed), *Tax Reform in Developing Countries* (Durham, Duke University Press, 1989), pp. 79-114.

[7] I. Trela and John Whalley, "Taxes, outward orientation and growth performance in the Republic of Korea" in J.K. Shirazi and Anwar Shah (eds), *Tax Policy in Developing Countries* (Washington, DC, The World Bank, 1991).

[8] M. Ahluwalia, "Policies for poverty alleviation", *Asian Development Review*, vol. VIII (1990).

[9] J. Bhagwati, "Poverty and public policy", *World Development*, vol. 6 (1988).

low income group, a thin middle range and a high concentration of income and wealth at the top. Tax policy cannot be indifferent to this distributional aberration for both social and political reasons. The revenues, therefore, must be raised through non-regressive taxation.

(vii) Other considerations: Tax reforms, to be successful, must take into account initial conditions at home and abroad. The tax structures which look ideal on paper may not be feasible to administer.[10] Similarly, success of tax reform depends on the credibility of the tax regime; a stable tax policy environment enhances credibility and helps economic agents to plan their economic decisions. A comprehensive tax reform has a chance of a better success than piecemeal reforms. It is also found that tax reforms undertaken as a substitute for expenditure reforms have not met with the same degree of success.[11] Finally, the crisis induced tax reforms (e.g. to meet grave budgetary crisis) have met only with partial success primarily due to inadequate preparation, training of tax administrators and taxpayer education.

The present study on tax system reforms in six developing countries of the ESCAP region takes approximately their 1980 tax structures as the base and reform measures introduced since then are analysed and judged. The year 1980 was crucial not only as a decadal beginning but also as the point of a radical change in both the international and domestic economic environment that began with the first hike in petroleum prices in 1973. One could add that the year also saw the beginning of a change in the perception about the role of government vs the private sector in the economy, which found its reflection in tax policies. Reforms were initiated early in the decade in all the countries but the pace of reform accelerated towards the end of the decade or in the early 1990s.

II. EXPERIENCE WITH REFORMS IN SIX COUNTRIES

The level and structure of taxation

The developing countries typically raise in taxation a lesser proportion of their GDP than the share of GDP raised in taxes by the developed countries. Since the ability to raise revenue by taxation sets an important limit on the government's ability to spend, the level of government expenditure in the developing countries is also typically a lesser proportion of GDP than in the developed countries. Data in table 1 indicate the level of government expenditure and taxation in selected developed and developing countries.

The differences in the level of government expenditure in the developed and developing countries also reflect the differences in the quantity and quality of public services available to their respective populations. The point is that the developing countries have not succeeded in raising the revenue share in GDP and have depended excessively on foreign aid, or have run excessive budget deficits. Raising of tax revenue has been easier in the developed

[10] R.J. Chelliah, "Agenda for comprehensive tax reform", C.N. Vakil Memorial Lecture at the Indian Economic Association Conference (Bombay, 1994), for example, states, "A theoretically perfect tax structure would be of no avail if it cannot be administered effectively ...".

[11] The World Bank, *Lesson of Tax Reform* (Washington, DC, 1991).

Table 1. Relative share of government expenditure and tax revenue as percentage of GDP in selected developed and developing Asian countries

	Government expenditure as percentage of GDP		*Tax revenue as percentage of GDP*	
	1980	*1993*	*1980*	*1993*
Developed countries				
France	39.53	44.98[a]	36.67	37.44[a]
Germany	32.23	37.23	29.33	32.79
Netherlands	53.62	53.87	44.76	46.45
Sweden	39.52	51.81	30.22	31.88
United Kingdom	38.05	43.18[a]	30.41	32.87[a]
United States	22.03	23.53	18.50	17.82
Developing countries				
Bangladesh	10.11	17.04	7.78	9.51
India	13.25	16.67	9.76	10.79
Indonesia	23.82	16.67	21.78	14.36
Malaysia	28.49	25.82	23.52	20.76
Pakistan	17.54	24.26	13.35	13.00
Philippines	13.36	18.47	12.53	15.60
Republic of Korea	17.25	16.85	15.50	16.30
Singapore	20.04	20.05[a]	17.52	17.29[a]
Sri Lanka	41.36	26.96	19.14	17.46
Thailand	18.91	15.92	13.25	16.18

Sources: International Monetary Fund (IMF), tape No. 95517F, *International Financial Statistics Yearbook 1994*, *International Financial Statistics*, August 1995 and *Government Finance Statistics 1994*; and Asian Development Bank, *Key Indicators of Developing Asian and Pacific Countries 1994*.

[a] 1992.

countries owing to favourable structural factors. The tax base could be relatively easily extended to almost the entire population in economies which are more fully organized with well developed systems of record keeping and accounting; both higher levels of efficiency of tax administration and of voluntary compliance made tax enforcement and collection more effective; and the mainly income based taxation made the tax system more responsive to changes in income levels and tax revenues more elastic requiring fewer discretionary changes in the tax system to meet revenue requirements. The developing countries have generally lacked these characteristics.

A comparison of the revenue structure of the six countries under study reveal the typical developing country characteristics of a relatively low tax weight in GDP and the dominance of the conventionally called indirect taxes (table 2). However, there are quite a few differences among the six countries that are worth noting. First, the tax/GDP ratio remains the lowest in Bangladesh, true to its characteristic of being the only least developed country in the group. Secondly, the tax GDP/ratios have increased recently in 4 of the 6 countries. About a 2 percentage point increase has been registered in Bangladesh, India and the Philippines, and a about 5 percentage point improvement has taken place in Thailand in 1992 over those in 1980. The ratios declined in Indonesia, owing to a decline in the oil revenue which has been the dominant source of government revenue, and in Pakistan, apparently for insufficient

Table 2. Tax structures in sample countries

			Share of direct and indirect taxes in total tax revenue			
	Tax/GDP		*Direct*		*Indirect*	
	1980	*1992*	*1980*	*1992*	*1980*	*1992*
Bangladesh[a]	7.7	9.3	17.7	24.8	82.3	75.2
India[b]	14.6	16.8	16.4	15.8	83.6	84.2
Indonesia	22.8	17.0	77.0	57.1	23.0	42.9
Pakistan[a]	14.0	13.2	20.1	20.6	79.9	79.4
Philippines	12.7	15.2	30.5	33.6	69.5	66.4
Thailand	12.5[c]	17.1	22.5[c]	30.3	76.5	69.7

Sources: Country case studies published in this volume.

[a] 1980/81 and 1992/93.
[b] 1980/81 and 1991/92.
[c] Average 1980-1982.

tax efforts. Thirdly, the share of direct taxes in total tax revenue is still relatively low in all of them, though the share has enhanced considerably in Bangladesh, Philippines and Thailand.

Bangladesh collected about a quarter of its tax revenue from direct taxes in 1992 compared with less than a fifth in 1980; 33.6 per cent of the Philippines' tax revenues and 30.3 per cent of Thailand's were raised in direct taxes in 1992 compared with 30.5 per cent and 22.5 per cent respectively in 1980. India and Pakistan, on the other hand, have not succeeded in enhancing the approximately 16 and 20 per cent share of direct taxes in their total tax revenues, while Indonesia's declined from 77 to 57 per cent reflecting a decline in the importance of oil revenue. However, since the early 1980s, the share of non-oil tax revenue in Indonesia has steadily increased from around 30 per cent in 1983 to about 65 per cent in 1993. The share of income taxes in total non-oil tax revenues have reached 30 per cent. These signify some fundamental changes in the country's revenue structure.

In all six countries, the bulk of the revenue from direct taxes is derived from the personal and company income taxes. Wealth and gift taxes also feature in the tax systems, but their revenue importance has been insignificant. The broad categories of indirect taxes are: customs duties in which import duties predominate, and excise and business/sales taxes are major levies on domestic production and trade. There are other miscellaneous taxes and fees which together account for no more than 4 to 6 per cent of tax revenue. A breakdown of the relative contribution of these categories of taxes to revenue is given in table 3. As stated earlier, income taxes contribute a relatively small share of tax revenue in these countries though their share has increased in recent years. Recently, excise/sales/business taxes have been converted into a multi-stage value added tax in Bangladesh, Indonesia, Philippines and Thailand. India and Pakistan have yet to introduce a comprehensive system of VAT. Comparison of the relative importance of taxes on domestically produced goods and services and that on foreign trade transactions indicates a decline in the importance of foreign trade taxes.

Table 3. Share of individual taxes in total tax revenue

		Direct taxes		*Indirect taxes*					
		Personal income tax	*Corporation tax*	*Others*	*Customs duties*	*Excise duties*	*Sales/business/ value added taxes*	*Others*	*Total taxes on domestic goods and services*[a]
Bangladesh	1980	12.4	..	1.6	42.2	21.0	19.1	3.7	43.8
	1992	17.9	..	1.0	36.2	1.8	36.8[b]	6.3	38.6
India	1980	7.6	6.6	1.2	17.2	32.8	4.2	9.1	46.1
	1992	6.6	7.1	1.3	22.3	27.0	5.5	8.0	40.5
Indonesia[c]	1980	77.0 (6.2)			7.6 (26.0)	..	..	6.8	9.1 (31.1)
	1992	57.1 (25.1)			7.1 (10.5)	..	..	4.9	30.9 (45.4)
Pakistan	1980	18.1		2.0	41.1	27.0	7.4		36.7
	1992	18.9		1.7	43.6	20.1	13.3		35.7
Philippines	1980	30.5		1.9	22.4	18.4	19.1	7.6	45.1
	1992	33.6		1.3	34.9	13.2	13.3	3.7	30.2
Thailand	1980	9.7	12.8	..	25.0	25.5	21.8	5.2	52.5
	1992	11.3	18.9	..	18.5	22.0	24.8	0.7	47.5

Sources: Country case studies published in this volume

[a] Excise, sales/business and value added taxes
[b] Includes taxes supplementing VAT
[c] Figures in parenthesis indicate shares in total non-oil revenue

Commodities subject to tax under excise and sales taxes in all the countries are many and varied. Similar multiplicity and diversity characterized customs tariff structures of each of the countries. The structure of tax rates also varied in respect of the number of rate bands and the height of individual rates. In each case however commodities could be classified into consumption goods, intermediate goods and capital goods, and a general pattern of higher taxes on the first compared to the latter two categories could be observed. On equity considerations higher taxes were levied on so-called luxuries while essentials were free or lightly assessed. The resulting rate structures became complicated. A simplification of the rate bands and a lowering of tax rates have been major objectives of recent reforms in these countries. Import tariffs have been considered to have discriminated against exports by diverting resources to import substituting industries making domestic sales more profitable than exports. It had also helped to keep the domestic currency overvalued militating against the interests of export industries. Over time, the protected domestic industries in the absence of competition, developed inefficiencies resulting in higher costs and prices to the detriment of the interest of domestic consumers. Other anomalous and discriminatory consequences followed from administering the complicated rate schedules on very long lists of commodities.

Excise taxes, traditionally imposed on selective produce, were extended to domestic production of manufactures to compensate for the loss of revenue from import duties where imports have been restricted (whether by tariff or quota). On equity or social considerations (e.g. to discourage consumption of certain commodities), differentiated rates have also been used for excise duties. Excise duties, in principle, could also be used to equalize the tax burden on imports and on domestic production where both imports and domestic production of the same or similar products competed in the market. That has not always happened since policies always tended to give import substituting domestic production "a chance".

Both imports and domestic production have also been subjected to sales tax on revenue considerations. Differentiated rates have often been used on equity considerations. Sales taxes have been collected at the points of entry (in the case of imports) and production (in the case of domestic production) rather than at the point of sale on the basis of value added at that point.

Despite attempts to introduce progressivity in the rate schedules of the indirect taxes, research findings have tended to confirm them as being regressive. Their incidence falls primarily on consumption of the relatively poor who spend a higher proportion of their income on consumption. The lower income groups bear a greater burden of taxation than would be justified on the ability criterion. These taxes are inherently prone to introducing distortions into production, trade and consumption patterns away from efficiency norms.

The income tax has played a relatively small role in raising revenue. The tax base has been narrow, the rate schedules have often been steeply progressive, and tax avoidance and evasion as well as numerous measures of concessions to taxpayers have limited the revenue potential while distorting the incentive structure.

Measures of recent tax reforms in the countries under study have sought to address and rectify these deficiencies of their tax systems. Tax reforms have been geared to the following four areas in the countries under study: a simplification of the rate structures; streamlining of the incentive structures; a broadening of the tax bases; and improvement in tax administration and the efficiency of tax collections. The reforms have encompassed both direct and indirect taxes.

Reform of direct taxes

In the case of direct taxes, consisting of the individual income tax and the corporate tax, the move has been in the direction of reducing tax rates lessening their progressivity and consolidating the number of taxable income slabs to which differentiated tax rates applied. In the case of the personal income tax, the minimum threshold income for tax exemption has been raised to provide relief to lower income people. The other reforms have been a rationalizing of allowable deductions in the form of personal, dependency, educational and investment allowances to provide relief as well as incentives to taxpayers for savings and investment.

In the case of corporate taxes also, rate reduction and removal or rationalization of discrimination based on such criteria as the listing or nonlisting in the stock exchange, partnerships vs public limited companies, registered vs unregistered companies, and so on, have been the target of reforms. The investment incentives in the form of tax holidays, accelerated depreciation allowances and allowable business expenses have also been subjected to scrutiny since they result in substantial revenue losses, introduce distortions and do not often serve their intended purposes. Another issue addressed has been the question of taxing dividends at the hands of the shareholders resulting in possible double taxation of profit incomes.

In Bangladesh, the rate reductions of the individual income tax started as far back as 1978/79 when the highest marginal rate of tax was reduced from 70 to 60 per cent. Since then the rate has been reduced through 50, 45, 30, and finally to 25 per cent in 1993/94. Only four taxable income slabs were designated including the exemption slab ranging

from 0 – Tk 40,000 (Tk 20,000 in 1982). Certain concessions, such as entertainment and conveyance allowances, were withdrawn or reduced for calculating taxable incomes. Also higher rentals were imputed to rent free accommodation provided to salaried persons to determine taxable income. A 15 per cent tax credit has been allowed for permissible investment on the amount of tax assessed replacing the practice of deducting all investments subject to a maximum ceiling of Tk 200,000, from incomes to arrive at taxable income. Donations are no longer tax deductible.

The highest marginal rate of tax for a registered partnership was 30 per cent of total income after deductible expenses from sales with an exemption limit of Tk 20,000. There were six tax brackets, the highest rate being applicable on income exceeding Tk 160,000. The maximum rate was reduced to 25 per cent and the number of tax brackets reduced to 4 as from 1986/87. In the case of a company, the tax rate was fixed at 50 per cent for an industrial company and 60 per cent for other companies including banks and financial institutions in 1980. The rates have been further differentiated into three though their heights have been reduced. The differentiation based on trading and non-trading companies is intended to encourage companies to enlist in the stock exchanges. The three rates of company taxes are: 40 per cent for a publicly traded company, 45 per cent for a company not publicly traded, and 50 per cent for other companies. Companies are charged on their total income, excluding inter-corporate dividend and any capital gains realized within two years of acquisition of an asset.

Reform of the direct tax system in India has a long history. Guided principally by consideration of equity, India had instituted a steeply progressive rate schedule for personal income taxation, the highest marginal rate staying at 93.5 per cent even in the early 1970s. That rate has gradually been reduced and set at 40 per cent in 1994/95. The tax base has remained narrow, only 0.6 per cent of the population paying income tax in 1991/92, only 6.1 per cent of GDP and 18.8 per cent of non-agricultural GDP being assessed to tax.

A major reason for the narrow base of income taxation in India has been the exclusion of agricultural income from the purview of taxation. In addition, high initial exemption limits, which at one time reached as high as seven times the per capita income in the country, generous concessions given as investment allowances for investment in certain specified financial instruments, and failure to include in-kind perquisites in the tax base, have been found responsible for the erosion of the tax base.

Under the system of company taxation in India, taxes are levied on the total profits of a corporation treating it as a juristic person, and the dividends are again taxed in the hands of the shareholders. This system of taxation discriminates against incorporated business *vis-à-vis* unincorporated businesses, dividend incomes are taxed more heavily than other incomes, retained profits are treated more favourably, and favours debt finance over equity finance. Yet, there has been no attempt to change the system. Until 1993/94 the rates of company taxation were different for "widely held" and "closely held" domestic companies. This distinction was removed in the 1994/95 budget and the tax rates for all domestic companies were set at 40 per cent, with an additional surcharge of 15 per cent on companies with income in excess of Rs 75,000. The tax treatment of foreign companies is similar, with the exception that they are not given exemption on profits from exports and limits are set on their head office expenses.

In Indonesia, reform of the income tax system has considerably simplified the rate schedule of personal income tax and streamlined the basic exemptions as well as other allowances. Prior to 1985, there were 19 different tax rates ranging from 10 to 50 per cent on different income slabs. This has now been reduced to only three rates of 15, 25 and 35 per cent. Basic exemptions are granted to the individual taxpayer as a personal allowance, for a spouse, and other dependants up to a maximum of three individuals. Thus, the reforms have considerably lowered the tax rates, in addition to their simplification, and have granted more liberal basic exemptions to help relieve the tax burden on the low income people. The reforms, however, have broadened the tax base by subjecting more types of income and in-kind perquisites to taxation and by reducing allowances, deductions, exemptions and tax expenditure provisions. All capital gains are to be taxed as ordinary income in stead of only short-term gains as before.

The reforms introduced since 1984 have integrated the rates of personal income tax and the corporation tax thus simplifying the system further. Virtually all special tax incentives for investment have been eliminated and allowable deductions have been narrowed. Non-deductible expenses include amounts paid as dividends, premium for life insurance and, health insurance unless paid by the employer, excessive compensation paid to shareholders for work performed, gifts, personal expenses and contributions. In-kind payments made to employees such as company houses, business automobiles and holiday leaves, are also not deductible. Investment incentives in remote areas are given in the from of more generous depreciation and exemption of in-kind payments from individual income tax.

The personal and corporate income tax systems in Pakistan are characterized by high marginal rates of taxation, buttressed by a whole series of concessions granted to tax base in the form of exemptions and allowance, which considerably erode the tax base.

The Philippines uses a schedular approach to individual income taxation, first introduced in 1981 replacing the practice of taxing the individual's global income at progressive rate schedules. Under the schedular approach, individual incomes were grouped into three categories, namely, compensation incomes arising from employment, incomes from business and professions, and passive incomes, e.g. rent and interests. Both compensation and passive incomes were subjected to tax on a gross basis, except for a minimum subsistence allowances on compensation income. All other deductions were disallowed. The tax rates on compensation income were set at 0 to 35 per cent in contrast with the 3 to 70 per cent rate schedule existing under the previous system. A net income base was used for taxing business and professional incomes but a high tax rate schedule of 5 to 60 per cent was applied. A 15 per cent tax rate was imposed on passive income and they were subjected to a final withholding scheme in view of the widespread practice of non-declaration of passive incomes.

Under reforms introduced in 1986, a uniform rate schedule of 0-35 per cent was applied to compensation as well as business and professional incomes. The tax rate on passive incomes was raised to 20 per cent. The other important highlights of the 1986 reforms included the permission of married couples to file their income tax returns separately so as to reduce their tax burden compared to the liability they would incur with their incomes aggregated and subjected to progressive rates of taxation. The minimum exemption limit was raised and set at 24,000 pesos in 1986 thereby freeing families at the low end of the income scale from income taxation. While instituting uniform tax rate on compensation as well as

on business and professional incomes, ceilings were prescribed on deductions to be allowed for calculating net incomes from business and professions.

In the area of company taxation the 1986 reform prescribed a single uniform rate of tax at 35 per cent, thus abolishing a lower rate which used to apply on corporate net incomes of 100,000 pesos or less. The 1986 reforms withdrew most allowances, exemptions and tax concession except those provided in the basic tax code or granted under international tax agreements. In stead of incentive provisions of allowances and deductions, a subsidy scheme was instituted in order to make the system of tax expenditures more transparent, efficient and accountable.

Reforms of the income and corporate tax in Thailand also have aimed at broadening of the tax base and a simplification and lowering of the tax rates with less emphasis on progressivity. The personal income tax is levied on the global incomes of a taxpayer. Assessable income is classified into eight categories. Though they are not taxed under separate schedules, the rates of deductible expenses vary according to the source of income. Personal, spouse, child and education allowances together amounting to B 75,000 are allowed and investment allowances for insurance, provident fund contributions and donations are also allowed within certain limits. Five different tax rates of 5, 10, 20, 30 and 37 per cent apply, the lowest rate on taxable incomes falling below B 100,000 and the highest rate on taxable income exceeding B 4 million. The burden of income tax with the rather generous provisions of allowances and low rates appears to be rather light on the taxpayer in Thailand. Thailand is using tax-withholding at source for several categories of income at the taxpayers' option who can deduct such tax payments from the final assessments under the prescribed rate schedules.

Corporate tax in Thailand is levied on the net profit of a juristic company, and limited or registered partnerships organized under Thai or foreign laws. Net profits are calculated after deducting several categories of business expenses specified in law. Inter-corporate dividends are totally or partially excluded from net income subject to certain conditions. Charity payments and donations are deductible subject to a limit of 2 per cent of net profit. The rate of cooperate tax in Thailand is a flat 30 per cent of net profit but profits disposed of outside of Thailand are subjected to a lower rate of tax. Subject to certain conditions, income paid to a juristic company or partnership organized under a foreign law and not carrying on business in Thailand is subjected to a 15 per cent tax rate.

Reform of indirect taxes

Significant reforms have been effected in the area of indirect taxes. Introduction of the value added tax in four of the six countries under study forms the most important step in the reforms of the indirect tax system. The VAT has been adopted at a single uniform rate by Bangladesh (15 per cent), Indonesia and Philippines (10 per cent) and Thailand (7 per cent). The consumption type of VAT adopted by these countries makes consumer goods and services only the subject of taxation at different points of distribution and sale. Full tax credits are allowed at each stage for the tax paid at an earlier stage. Only the net value addition at each stage thus becomes the tax base.

The tax base covers a wide range of manufacturing products and services. Many essential commodities, such as unprocessed food, have been left out to reduce the regressivity of

the tax, and special higher rates of VAT or compensatory excise/sales/business taxes, which the VAT has replaced, have been levied on luxury items. Exports have been zero rated while imports have been subjected to VAT on the duty paid value.

Several merits are attributed to the VAT. VAT satisfies neutrality as tax burden falls equally heavily on different products; the tax-credit system avoids any cascading of the tax burden; and the VAT encourages exports since under the destination principle used in imposing VAT, exports are zero-rated. It has enabled an expansion of the tax base than was possible under the old taxes that it replaced.

India and Pakistan have not yet adopted the VAT. India adopted a modified value added tax since 1986 with limited coverage of commodities subject to central excise duties. Coverage has expanded gradually and by 1994/95 was expanded to include capital goods and petroleum products. Sales tax in India, being a provincial subject, could not be replaced by a uniform VAT. A study has been conducted recently to examine the scope and possibility of replacing the sales tax with VAT. The task is complicated by the fact of the split between the federal and state governments of indirect tax responsibilities, and variations in the sales tax profiles among the states. In Pakistan, the sales tax law prescribed a value-added type tax in 1990, extending sales tax collection on value added at each stage of processing and trading. However, the tax has continued to be collected at the manufacturing and import stages instead of at the sales point and, therefore, a move towards the VAT has not materialized.

Countries which introduced VAT have mostly abolished the sales tax and substantially reduced the list of items on which excise duties are levied. Items such as tobacco, alcoholic beverages, sugar and a few others are still subject to excise taxes. A transition to a comprehensive system of VAT is not yet complete however. Bangladesh and Thailand, for example, initiated the switch to VAT only since mid-1991 and the beginning of 1992, respectively.

The other major area of reform has involved the structure of import tariffs. Generally, the move has been towards lower, less differentiated and more uniform tariff rates. As part of the streamlining of the protective functions of the import regime, there has been a move also from quantitative restrictions to tariffs and from specific to ad valorem rates of duties along with a lowering and rationalizing of the rates. The impact of recent reforms on the structure and magnitude of the duty rates is clearly illustrated in the case of Bangladesh and Indonesia.

In Bangladesh, for example, within the short period between the 1992 and 1994 fiscal years, the number of duty rates were reduced from 18 to 11, the dispersion of the rates (measured by the coefficient of variation) reduced from 72 to 62 per cent, and the number of H.S. codes with above 100 per cent duty rates were reduced from 264 to 17 and with zero rates from 395 to 296. The unweighted mean duty rate was reduced from 57 to 36 per cent, though the weighted mean rate showed a less pronounced decline from 24 to 22 per cent. These are remarkable changes effected in such a short period. Similarly, in Indonesia, the index of dispersion of the duty rates was reduced from 108 in 1985 to 83 in 1992, the unweighted average rate of duty from 27 to 20 per cent, and the weighted (by import value) average rate from 13 to 9 per cent. The changes appear more striking from the pre-1985 rates, which had already come down as a result of reforms initiated since 1983.

Pakistan also effected a series of reductions in import duties, and partly as a result the average rate of duty came down from about 26 per cent in fiscal 1980 to 21 per cent in 1992. However, the relatively low average rate observed largely reflected duty exemptions on substantially large part of imports. The average statutory rate was 58 per cent though the effective rate was no more than 21 per cent in 1992. Completely duty-free imports were allowed to industrial users, public sector agencies, priority industries, backward regions etc. as incentive measures, which accounted for as high as 48 per cent of imports in fiscal 1991 and 41 per cent in 1992, while rates on dutiable imports remained high. They could not be reduced without a substantial further loss of revenue. The country could not afford that loss as it was already facing large deficits and customs duties constituted the most important revenue source contributing one third of the total. On the other hand, the concessions have introduced major distortions in tariff structures and resulted in both allocative as well as x-inefficiencies, making tariff reform an important but difficult task for the Government to undertake.

Tariff reforms in Thailand also had the similar effect of lowering the rates, and reducing, simplifying and rationalizing the rate bands. Thailand still had 39 different rates ranging from 0-100 per cent. Plans were afoot for further simplification and reduction in the rate bands. Reforms of the customs tariff structure were initiated in 1988 and implemented gradually since 1990 – industry by industry.

Tariff reduction and rationalization have been the subject of recommendations by expert committees in India since the mid-1980s. Although some rationalization was effected in the late 1980s by reducing rate differentiation and switching from quantitative restrictions to tariffs, the tariff rates showed a sharp increase rather than a decline. Thus the import-weighted average rate of nominal tariffs increased from 38 per cent in fiscal 1981 to 87 per cent in fiscal 1990. The rate rise was necessitated by the central government's greater dependence on customs revenues as larger proportions of individual income tax and central excise revenues had to be statutorily transferred to the states. Since July 1991, as part of its overall reform programmes introduced then, India's import duty structures have been considerably rationalized. That included a reduction in the highest rate of duty from 150 per cent in fiscal 1992 to 65 per cent in fiscal 1994, a reduced and uniform rate of 25 per cent on capital goods and parts, and reduction of the number of duty rates from 20 to 5-6, along with reduction of end-use exemptions granted earlier.

Reform of tax administration

Reform of the system of tax administration is considered important because it is the effective enforcement and/or compliance of the tax provisions on which depends not only the realization of revenue potential of tax measures but also the fulfilment of other objectives, such as efficiency and equity. However, an effective enforcement of the existing legal provisions may not be enough. Tax administration should be able to expand the base of taxation both within the framework of existing legal provisions as well as by recommending fresh legislation on the basis of a sound system of information gathering. On the other hand, tax legislation and administration should aim at eliciting voluntary compliance by taxpayers. Deficiencies have been found to exist in the present system of tax administration in most of the countries and efforts have been made to remove them.

Enforcement of the existing legislative provisions is found to be hampered by inadequate staffing of tax administration agencies and offices; many complications in the existing legal provisions; and inefficiency and corruption among administrative staff which is often encouraged by the complexity of the laws and regulations.

The hierarchy of tax administration in Bangladesh, for example, consists of the National Board of Revenue at the apex body with appellate, supervisory and training jurisdictions. Tax collections are actually undertaken by the separate collectorates of customs and excise, on the one hand, and the zonal commissioners of income tax, on the other. The set up has been found to suffer from the shortage of staff and officers which affect both the quality and quantity of assessments, and result in staggeringly high pending cases and arrears of outstanding demands. The survey, research, inspection and staff training work could not also be properly carried out. To improve this situation, two additional members have been recently appointed to the National Board of Revenue. The number of zonal income tax commissioners has also been increased and the training capacities at all levels strengthened. Bangladesh has also recently tried with the self-assessment system for income tax, a system that saves time and administrative costs, and could encourage voluntary tax compliance. However, certain restrictions, such as the requirement of a minimum tax payment of 1,500 taka in order to qualify for self-assessment, have reportedly defeated the purpose of the scheme which could otherwise bring a larger number of lower income people under the tax net on the basis of self-disclosure.

The deficiencies in the Indian system of tax administration have also been reported in terms of complicated and outdated code of laws and procedures; unsatisfactory inspection systems; out-moded system of reporting and monitoring; inadequate training of officers and their improper placement; frequent changes in rules and procedures; and delay in the disposal of appeals by tax tribunals. Expert committees have recommended measures to update and simplify procedures and to improve the system of inspection, monitoring and training facilities, and also a proper classification and valuation of exciseable and imported goods. Some of these recommendations have been implemented in the 1994/95 budget.

The system of tax administration in Indonesia has undergone substantial reforms since 1985 and currently possesses a number of features making the tax administration in that country considerably easier and more productive. The income tax system in Indonesia is now based on self-assessment, with the tax administration only selectively auditing a sample of the returns. With greater simplicity and clarity in the income tax laws and procedures, taxpayers now can detect and act against arbitrary behaviour by tax authorities. On the other hand, the authorities themselves are better able to resist demands from taxpayers for exemptions and exceptions.

Other features of the new tax system include improved procedures for refunds and appeals with specific time limits for response to the taxpayers. At the same time, the new tax system reduces the direct cost of administration. The progress in the implementation of VAT is similar to that of the income tax legislation. Large firms find the VAT less complicated than the former sales tax. However, firms which have no good records and administration find VAT return more burdensome. The full implementation of the tax legislation thus still requires improvement in the tax administration and the regulatory infrastructure involving registration of taxpayers, tax assessment and audit, and collection procedures. The legal and accounting practices need further improvement.

The tax administration in Thailand is found to suffer from similar disadvantages such as lack of well-trained staff, inefficient and corrupt officials, complications of laws and procedures, and insufficient information base as well as insufficient capacity for speedy processing of information, although computerization has recently improved the system considerably. The Government has given top priority to reforming and improving the system of tax administration.

As in Bangladesh, Indonesia and elsewhere, Thailand has also adopted a system of withholding taxes at the source for a number of categories of income, which decreases the opportunity for non-compliance. Presumptive taxes in the form mainly of imposing a lump sum tax on small businesses, transport companies and other "hard-to-tax" groups to obviate the need for filing returns and difficult assessment have been used in Bangladesh, India Indonesia and Pakistan.

All the six countries have emphasized the need for a greater flow of information between the taxpayers and tax authorities. In that context, computerization of the processing of data and information is found to be essential. Emphasis has also been put on taxpayers' education and building up of a relationship of trust and confidence between taxpayers and authorities, a relationship that can be essentially distrustful. In so doing, accurate and speedy collection and processing of information assume singular importance.

Impact of reforms

The objective of rapid economic growth encompassed the goals of mobilization of saving and acceleration of investment in both private and public sectors and of ensuring both allocative and x-efficiency in production. A large number of policies and measures have interacted to determine the observable outcome. The impact of tax measures on the achievement of these basic goals is difficult to measure and isolate from those of other policies. The analyses carried out however point to certain general directions. The reforms on a broad scale have been initiated only recently and only partially implemented thus far. Their full impact could be expected to materialize only over a period of time.

Revenue productivity

The elasticity and buoyancy calculations as measures of responsiveness (productivity) of the tax system and of individual taxes to changes in income do not seem to give any clear-cut indication of the tax systems being more productive over time in the countries under study. Only in the case of the Philippines, the buoyancy coefficient of the tax system is shown to improve remarkably from 0.85 during 1980-1985 to 1.36 during 1986-1990 and that of the income tax from 0.72 to 1.58 (personal income from tax 0.11 to 1.99 and corporation tax 1.9 and 1.36). Import duties displayed a considerably greater buoyancy (0.86 and 2.18), the business tax moderate advance from 0.32 to 0.48 while excises dropped in buoyancy from 1.18 to 0.50.

In Indonesia and Thailand, the buoyancy coefficient of the tax system has varied from year to year but seems to have improved in recent years. In Thailand, for example, the coefficient rose to 1.33 during 1987-1992 from 1.20 during 1980-1986, although the coefficient dropped to 0.52 in 1992, perhaps reflecting the change-over to VAT and the political events during the year with adverse effects on tax collection. In Indonesia, the measure of buoyancy shows considerable improvements for non-oil tax revenues since 1985. In all three South-East Asian

countries the buoyancy of direct taxes has improved. The share of direct taxes in total revenue has also improved. The more responsive tax systems have produced favourable results for revenue and overall budgetary balance in the three countries.

Revenue buoyancy of tax systems in Bangladesh and India has been more subdued. In Bangladesh, the buoyancy for the tax system during 1975-1991 has been found to be 1.10. Surprisingly, the indirect taxes (1.14), especially excise duties (1.17), have been found to be more buoyant than the direct taxes (1.01 for the income tax). The tax/GDP share in Bangladesh failed to improve between 1980 and 1991. The buoyancy coefficient of the tax system rose to 1.12 when the period was extended to 1993 when some of the reform measures took effect. The tax/GDP ratio also improved since 1991.

In India, the buoyancy coefficient of the tax system showed marginal improvement when measured for 1960/61 – 1991/92 (1.18) as against 1960/61 – 1990/91 (1.16); calculations for the latter period captured some of the effects of reforms being implemented since mid-1991. The tax/GDP ratio in India stagnated at 16.5 in 1990/91 as in 1985/86 but showed an improvement to 16.8 in 1991/92.

Poverty and equity

It is generally agreed that taxes *per se* can do very little to alleviate poverty. A steeply progressive system of taxation, provided it can be effectively enforced, can reduce the height of top incomes but can do very little to raise the bottom ones. Public expenditures, if directed to raise lower incomes through cash and in-kind benefits to lower-income and poor people, can have a better impact on poverty.

The ability to do so however would depend on the productivity of the tax system. From this point of view also highly progressive tax systems have not been found to be helpful. Progressivity of the taxes can in fact reduce its productivity as illustrated by the "Laffer curve". Highly progressive tax rates generate tax resistance, encourage tax evasion and avoidance and increase administrative complications. Furthermore, the exceptions and exemptions introduced into the system to counter the disincentive effects on private sector economic activities erode the tax base and further complicate tax administration. The six countries therefore have moved towards less steep progressivity in tax rates with fewer exemptions and exceptions, thus widening the tax base.

The impact of the tax system on the overall distribution of income also cannot be judged independently of the incidence of public expenditure financed by taxation. Income distribution is also influenced by policies other than fiscal policies and measures. There are very few studies to indicate conclusively whether overall income distribution in terms of Gini-coefficient or percentile measures has improved or deteriorated over time. Different sample measures sometimes throw up conflicting evidence. Comparison, however, tends to show that poverty (measured by the ratio of the population below the poverty line defined in terms of a threshold level of income) has been reduced faster in the fast growing countries. All of countries have also implemented direct anti-poverty programmes over the years. It is generally agreed that faster rates of economic growth have made a greater impact on the reduction of poverty in the South-East Asian countries. Hence the emphasis on growth in recent policies in all countries.

There is more evidence however on the sharing of the burden of taxation. Evidence from all the six countries suggest that the incidence of taxation on different income groups is generally progressive in varying degrees.

The progressivity to the tax system is imparted, apart from the graduated rate structures which are often diluted by concessions and allowances, by the initial exemption limits of income taxation. These limits are usually set high enough to exclude lower income people from the ambit of the tax. Exemptions of basic essentials and graduated rates of commodity taxes have also contributed to progressive distribution of tax burdens. The replacement of the sales and excise taxes with their graduated rates by a flat rate system of VAT may be considered to introduce more regressivity or at least to reduce the accentuation of the progressivity of the tax system.

The VAT system, adopted by four of the countries, has however sought to retain the progressive feature by excluding essentials such as unprocessed food from the base of taxation and by using special higher rates of VAT. The relatively low rate of taxation used and the removal of the cascading effects through the tax-credit mechanism would further lighten the tax burden generally, though the burden imposed by the flat rate will be shared proportionally rather than progressively by consumers in different expenditure classes. The progressivity of the income tax rates has been considerably reduced in all countries. At the same time, exceptions, exemptions, concessions and allowances which used to erode the nominally progressive rates, have been reduced and/or rationalized.

Quantitative calculations of tax incidence and burden have been always problematic, more so in the developing countries for lack of appropriate data and also for the inapplicability of the general assumptions about the impact, shifting and final incidence of various taxes. Yet attempts have been made within the scope of the present studies to provide evidence on the extent of the tax burden borne by people in different income classes. Thus, in the case of the Philippines, the overall tax is found to be regressive from the lowest (P 8,000) income through middle ranges of income extending P 40,000, the percentage of income paid in taxes falling as income goes up through this range. Thereafter the burden becomes progressive, and quite steeply so after income exceeds P 80,000. This characteristic very pronouncedly appears in the case of direct taxes while the burden of indirect taxes appears to be, by and large, proportional. The relatively high share of income tax, (one third of total revenue) thus imparts progressivity on the tax system as a whole. In Pakistan the incidence of both direct and indirect taxes remains proportional until income level rises above Rs 4,500 per month, at which point both direct and indirect taxes tend to fall more heavily on higher income groups.

In India, the results of various incidence studies tend to confirm that both direct and indirect taxes distribute tax burden progressively, though the high and rising share of indirect taxes tend to reduce the progressivity of the tax system as a whole. Studies based on income tax statistics have shown that the degree of concentration of post-tax incomes is lower than pre-tax incomes.

The role played by the state at a given stage of development of the economy and society seems to be the product of interactions of the economic, social and political forces at that stage, and the ideas that they generate. In the developing countries, the role of the state as reflected in the proportion of national income mediated through the tax-expenditure process

is still relatively small. That has largely been the result of the inherent limitations of the prevailing economic and socio-political factors including the limitations on the effective exercise of the taxing power. At the level of ideas, the current trend is distinctly towards less government. With industrialization, urbanization, and a relative weakening of the traditional social network of institutions as informal support to meet social needs, government's role in providing social services nevertheless will remain important. Raising the productivity (revenue) of taxes therefore continues to remain a major immediate objective of tax reforms.

PART TWO:

THE CASE-STUDIES

BANGLADESH

I. SALIENT FEATURES OF THE TAX SYSTEM

Major taxes

The Government has played a very important role in all development activities in Bangladesh. The Government spent a formidable 15.3 per cent (1985-1990 average) of GDP, of which only around half (7.0 per cent of GDP) was financed through taxation, the rest being financed through external assistance and other non-tax governmental revenues. A basic objective of tax policies and measures in Bangladesh therefore is to mobilize resources for adequate funding of the public sector development programmes and to reduce dependence on foreign aid and borrowing. The Government of Bangladesh entered into a 3-year ESAF arrangement with the International Monetary Fund starting from FY 1991. One performance criterion under that arrangement is to bring about a significant improvement in the tax-GDP ratio during the programme period as way of stabilizing government finances. A number of measures were initiated by the Government under an elaborate tax reform programme which included the introduction of the value added tax (VAT) and the rationalization of the tariff structure. A broadening of the tax base, simplification of rate structure of taxes, the rationalization of legal issues relating to taxation, and the streamlining of tax administration have been other targets of tax reform measures.

Bangladeshi's tax structure is dominated by indirect taxes, which contributed three quarters of total tax revenue. Prior to the recent introduction of the value added tax (VAT), which replaced most excise duties and the sales tax, customs duty on imports, excise duties and selective sales taxes on both domestic production and imports formed the mainstay of the indirect tax system. The income tax on individuals, association of persons and the Hindu Undivided Family (HUF),[1] and a company tax are the main forms of direct taxation.

Individual income tax has been levied on a taxpayer's global income from all sources at graduated rates, with incomes below a certain threshold being exempt. Company taxes have been charged at flat rates on total profits but the rates varied according the type of companies and the nature of their businesses. Wealth and gift taxes have also been levied, although their contributions to revenue have been insignificant.

The income tax in Bangladesh levied on individuals, association of persons and Hindu Undivided Family and others is global in character i.e. income from all heads are aggregated

[1] This has been a tax entity in the country's tax history.

in the hands of a taxpayer and tax charged at progressive rates on the global income. Schedular rates are also applied in a few cases such as on intercorporate dividends, and capital gains if they arise out of transfers after a lapse of two years since the acquisition of an asset. Non-company non-residents are also taxed at a flat rate. The income from execution of contract work may also come under a schedular rate, if the contractor has no other income and he elects to be charged so. The tax on income from trucks and buses plying for hire is charged neither on the global nor on the schedular basis. Here the tax has been fixed depending on the carrying capacity of trucks and buses without any reference to income, a practice which is considered distortionary and discriminatory against other assessees.

A resident taxpayer is liable to pay tax on (i) all income received or deemed to have been received in Bangladesh, (ii) all incomes accruing, or arising or deemed to accrue or arise in Bangladesh, (iii) on all incomes received outside Bangladesh; and (iv) on all incomes accruing, or arising outside Bangladesh. A non-resident is liable to pay tax only on (i) and (ii) above. Thus, a non-resident is exempt from tax on incomes received or arising outside of the territory of Bangladesh. By paying a flat rate tax on his income in Bangladesh, he is also exempted from the graduated rates applied to resident taxpayers.

Besides the individual and company income taxes, wealth and gift taxes and a foreign travel tax have also featured among direct taxes in Bangladesh. Wealth tax is charged under the Wealth Tax Act, 1963. This tax is payable by individuals and Hindu Undivided Family in respect of his/its net wealth on the valuation date. The net wealth has been defined to mean the aggregate value of all assets as reduced by the aggregate value of all debts owed by the taxpayer on the valuation date. The expression "assets" has also been defined in the Act and includes all movable or immovable property. One residential house owned and occupied by a taxpayer for purposes of his own residence upto a value of Tk 5 million, raised from Tk 2.5 million in 1991 is exempted. Agricultural land valued upto Tk 300,000 raised from Tk 100,000 in 1991, is similarly exempt. Maximum net wealth not liable to wealth tax was enhanced to Tk 2.5 million in 1993 from Tk 1 million. As many as 20 types of assets are exempt from the payment of wealth tax. The maximum rate of tax has also been reduced from 2 to 1 per cent. The maximum rate of 1 per cent will apply when the net wealth including exemption ceiling exceeds Tk 1.25 billion, raised from previous Tk 1 billion.

The gift tax, which had been introduced in earstwhile Pakistan in 1963, was repealed in Bangladesh in 1985. It was thought that there was no rationale for imposing a tax on a person who was divesting himself voluntarily of an asset, whether movable or immovable, without any monetary considerations. Reduction of the multiplicity of taxes was another stated reason. However, gift tax is again chargeable on all gifts made as from 1 July 1991 at the following rate schedule:

(i)	Gift (exceeding the exemption limit of Tk 20,000) upto Tk 500,000	5 per cent
(ii)	On the next Tk 1 million in excess of 500,000	10 per cent
(iii)	On the next Tk 1 million	15 per cent
(iv)	On the balance	20 per cent

A foreign travel tax payable by all Bangladeshis travelling abroad was first introduce in 1980. Initially, the tax was payable by passengers travelling by air only. The rate of tax

was fixed at 5 per cent of the value of the ticket, subject to a maximum of Tk 750 and a minimum of Tk 100. There were a number of exemptions. In 1984 travelling abroad by land and sea was also subjected to tax at the rate Tk 50 and Tk 200, respectively. The exemptions, which were being misused to evade tax payment, were withdrawn in 1987. Since then tax rates were restructured several times. The following tax rates are currently in force:

(i) Tk 1,750 for an air traveller to North and South America, Europe, Africa, Australia and the Far East countries;

(ii) Tk 550 for SAARC member countries for each air traveller;

(iii) Tk 1,250 for an air traveller to all other countries;

(iv) Tk 150 and Tk 500, respectively, for travel by land and sea.

The excise duty and the sales tax, which along with customs duty, have dominated the revenue structure have been recently replaced by the value added tax. VAT has completely replaced the sales tax on imports and domestic production and most excise duties except three items, namely tobacco, alcoholic beverages and narcotics. Customs duties, mainly on imports, remain the most important source of government revenue.

There is practically no tariff on exports while most imports are subject to customs duty. The average rate of customs duty (normal tariff) currently stands at 36 per cent with an import-weighted average of 24 per cent. Imports is also subjected to VAT (at uniform rate of 15 per cent) and occasionally to supplementary duties; and with some exceptions, license fees and advance income taxes at a uniform rate of 2.5 per cent are also levied on importers.

The maximum statutory rate of customs duty is 300 per cent with a minimum rate of 0 per cent. However, rates above 100 per cent apply only on a few commodity groups such as alcoholic beverages and cigarette paper. For all practical purposes, 100 per cent is the statutory maximum rate. Generally, rates vary from 15 per cent on basic raw materials, 30 per cent on intermediate inputs, and 45 per cent on final consumer goods. Rates above 45 per cent are mainly on grounds of protection applied on the basis of specific recommendations of the Bangladesh Tariff Commission. Rates below 15 per cent are special user-specific concessionary rates to promote industry or to give relief to such sectors as health, education or agriculture. Customs duty on capital machinery import for export oriented industries has been withdrawn.

Growth and composition of tax revenue

The tax-GDP ratio is a measure of the success of the tax effort in mobilizing domestic resources. The tax share in GDP barely reached 8 per cent since the 1973 fiscal year, the first fiscal year of independent Bangladesh. Only since 1991, the ratio of taxes to GDP started showing an improvement (table 1).

The tax share in GDP rose from 3.5 per cent in 1972/73 to 7.0 per cent for the first time in 1975/76 and remained more or less static at that level upto 1990/91 despite many discretionary changes made in the tax measures during those years. In 1991/92 and 1992/93 the ratio increased noticeably to 8.5 and 9.3 respectively, reflecting the effects of reforms introduced since 1991.

Table 1. Tax share in GDP in Bangladesh
(Percentage)

Period	*Tax-GDP*	*Period*	*Tax-GDP*
1972/73	3.5	1983/84	6.8
1973/74	3.9	1984/85	7.0
1974/75	4.1	1985/86	6.9
1975/76	7.3	1986/87	7.1
1976/77	6.5	1987/88	7.3
1977/78	7.1	1988/89	7.4
1978/79	7.1	1989/90	7.8
1979/80	7.2	1990/91	7.6
1980/81	7.7	1991/92	8.5
1981/82	7.6	1992/93	9.3
1982/83	7.3	1993/94	–

Source: *Bangladesh Economic Survey*, various issues.

Table 2. Share of direct and indirect taxes in total revenue
(Percentage of total tax revenue)

Period	*Indirect*	*Direct*
1979/80	84.6	15.4
1980/81	82.3	17.7
1981/82	81.2	18.8
1982/83	78.9	21.1
1983/84	80.7	19.3
1984/85	78.5	21.5
1985/86	77.8	22.2
1986/87	77.9	22.1
1987/88	75.9	24.1
1988/89	76.8	23.2
1989/90	76.1	23.9
1990/91	76.5	23.5
1991/92	76.2	23.8
1992/93	75.2	24.8

Source: *Bangladesh Economic Survey*, various issues.

Indirect taxes have accounted for the major component of tax revenue (table 2), though their share has come down somewhat in recent years. Indirect taxes contributed 84.6 per cent of total tax revenues in 1979/80 and 75.2 per cent in 1992/93. The share of direct taxes to total tax revenue, on the other hand, went up from 15.4 per cent in 1979/80 to 24.8 per cent in 1992/93. This change is quite significant but the share of direct taxes in Bangladesh was still below those in many other developing countries. Besides, low per capita income, negligible tax on the agricultural sector and generous exemption and incentives that are provided under the personal income tax and corporate income tax, accounted for the relative low contribution of direct taxes to revenue.

Table 3. Share of individual taxes in total tax revenue

Item/ Period	Custom duty	Excise duty	Sales tax	Value added	Supple-mentary	Income tax	Land revenue	Stamps duties	Motor vehicles	Regis-tration	Narcotic tax	Others
1979/80	46.2	19.2	19.2	0.0	0.0	12.5	1.8	0.0	0.3	0.0	0.0	0.8
1980/81	42.2	21.0	19.1	0.0	0.0	12.4	1.6	3.0	0.2	0.0	0.0	0.5
1981/82	39.9	23.5	17.8	0.0	0.0	13.2	1.6	3.2	0.2	0.0	0.0	0.5
1982/83	42.0	22.2	14.6	0.0	0.0	14.6	1.1	3.2	0.3	0.0	0.0	1.7
1983/84	41.5	24.9	14.3	0.0	0.0	13.7	1.4	3.1	0.3	0.0	0.0	0.7
1984/85	39.3	24.8	14.4	0.0	0.0	13.7	1.4	3.9	0.4	1.4	0.0	0.8
1985/86	37.2	27.0	13.6	0.0	0.0	14.2	1.6	3.9	0.4	1.3	0.0	0.7
1986/87	40.2	23.4	14.3	0.0	0.0	14.3	1.5	3.6	0.4	1.7	0.0	0.7
1987/88	37.1	26.8	12.0	0.0	0.0	15.2	2.0	3.9	0.5	1.4	0.0	1.1
1988/89	37.2	28.6	11.0	0.0	0.0	15.3	1.7	3.5	0.4	1.3	0.0	1.0
1989/90	37.5	29.4	9.2	0.0	0.0	15.1	2.0	3.1	0.6	1.2	0.0	2.0
1990/91	36.5	26.8	12.9	0.0	0.0	16.8	0.9	2.9	0.5	1.1	0.3	1.2
1991/92	36.4	17.6	0.0	21.6	0.3	16.8	1.1	3.2	0.5	1.0	0.3	1.1
1992/93	36.2	1.8	0.0	26.2	10.6	17.9	1.0	3.1	0.5	1.0	0.4	1.4

Source: *Bangladesh Economic Survey*, various issues.

The share of customs duty in total tax revenue, which had stood at 46.2 per cent in 1979/80 declined to 36.2 per cent in 1992/93 (table 3). The decline in the share of custom duties partly reflected the impact of downward adjustment of custom duty rates following the on-going tax reform programme of the Government, and partly recent stagnation of imports into the country. The relative share of customs duty is however expected to decline with further reduction of duty rates and liberalization of the tariff structure under the on-going reform programme and improved revenue collection from the newly introduced VAT as well as from the income taxes.

Excise duty and sales tax, which accounted for 39.4 per cent of the total tax revenue in 1979/80, fluctuated around that level and stood at 39.7 per cent in 1990/91 before their replacement by the VAT and taxes supplementing the VAT. VAT and the supplementary taxes along with the residual excise (three kinds of products are still subject to excise duties) accounted for 37.2 per cent of total taxes in 1992/93.

The annual average growth rate of tax revenue in current market prices, which was 13.9 per cent during 1982-1989, increased to 16.0 per cent during 1990-1993 (table 4). Annual average growth of tax revenue in constant market prices (Base: 1984-1985 = 100) also increased notably from 3.5 per cent during 1982-1989 to 10.1 per cent during 1990-1993. The relatively high growth of tax revenue in constant market prices during 1990-1993 could be attributed largely to the fall in the inflation rate. For the whole period 1982-1993, annual average growth rates of tax revenue in current and constant market prices worked out at 14.9 and 6.2 per cent respectively.

Growth in recurrent revenue expenditure has also been held in check in efforts to improve the budgetary situation and generating more surpluses for financing developmental expenditures. Growth rate of government expenditure has been contained by imposing ban on new recruitments, slashing of subsidies to public sector enterprises and shutting down some inefficient public sector enterprises.

Table 4. Annual growth rates in tax revenue and revenue expenditure, 1981/82–1992/93
(Percentage change in constant and current prices)

Period	*Growth in tax revenue*		*Growth in revenue expenditure*	
	Current	*Constant*	*Current*	*Constant*
1981/82	10.7	0.1	24.8	13.0
1982/83	9.7	1.4	16.1	7.2
1983/84	11.6	-2.6	16.5	1.8
1984/85	18.1	6.2	17.1	5.2
1985/86	13.4	3.3	16.7	6.3
1986/87	19.4	7.5	15.7	4.2
1987/88	13.3	5.3	19.6	11.1
1988/89	12.1	4.1	30.4	21.0
1989/90	18.1	12.6	9.2	4.2
1990/91	10.4	0.9	8.5	-0.9
1991/92	21.3	16.4	8.1	3.7
1992/93	16.6	13.6	8.2	5.5
Average:				
1982-1989	13.9	3.5	18.8	8.0
1990-1993	16.0	10.1	8.3	2.7
1982-1993	14.9	6.1	14.9	6.2

Buoyancy and elasticity of different group of taxes have been calculated in reference to their bases by regressing the tax series unadjusted for discretionary changes (for buoyancy) and adjusted for discretionary changes (for elasticity). GDP at current market prices, non-agricultural GDP at current market prices or other relevant bases have been used. Table 5 shows estimated values.

As can be observed from table 5, elasticity and buoyancy coefficients of total tax revenue have been higher than unity, signifying that the tax system has been mildly responsive to changes in their base during 1975 through 1991. According to these estimates, the responsiveness of indirect taxes has been marginally higher than that of direct taxes in Bangladesh. This does not, however, mean that in formulating tax policy, Bangladesh should put more emphasis on indirect taxes than on direct tax.

Basic weaknesses of the tax system

Bangladesh's tax-system was thus characterized by a low tax-GDP ratio, a low ratio of direct tax to total tax revenue, and a relatively low ratio of domestically based indirect taxes to total indirect tax revenues. The low per capita income ($ 160), a low degree of urbanization (13 per cent), the narrow base of the organized industrial sector, and the virtual exclusion of agriculture from direct taxation, could account for the observed characteristics of the tax system. Long lists of exemptions from personal income taxation, the indiscriminate use of tax holidays under company income taxation offering total tax exemptions which companies frequently took advantage of to reduce tax liability even from taxable units, further eroded revenue productivity of taxes. The absence of a healthy tax compliance culture and weaknesses of tax administration were further factors lowering revenue productivity of

Table 5. Elasticity and buoyancy of taxes, 1979-1991

Taxes	*Base*	*Elasticity*	*Buoyancy*
All taxes (before introduction of VAT)	GDP at current market prices	1.07	1.10
Indirect taxes	GDP at current market prices	1.08	1.14
Direct taxes	Non-agriculture GDP at current prices	1.03	1.09
Custom	Dutiable value of imports	0.68	0.82
Sales tax	Duty paid value of imports	0.63	0.74
Income tax	Non-agriculture GDP at current prices	0.98	1.01
Excise duty	GDP at current market prices	1.14	1.17
All taxes (after introduction of VAT)	GDP at current prices (1974-1993)	1.09	1.12

taxes. The tax system thus lacked elasticity, requiring discretionary revenue raising measures in each annual budget, a process that could introduce considerable uncertainty into production and investment decisions.

The reliance on import taxation was overwhelming. Whether it was intended or not, the average effective rate of 39 per cent import duties far exceeded the average effective 8 per cent rate of domestic indirect taxation which implied a high degree of protection to domestic production. The system discriminated against exports and was favouring import substitutions. While protection is appropriate and warranted in selective cases, the experiences in developing countries show that a generalized anti-export bias is pernicious to the development of an efficient industrial sector capable of responding in a flexible manner to changing external conditions.

More than 80 per cent of dutiable imports are raw materials and capital goods. High effective rates of import duty were borne by industries using them and were thus heavily taxed. This was particularly serious for those export-oriented industries such as garments and light engineering goods in which Bangladesh has a comparative advantage as their competitiveness was seriously impaired by import duties.

Import duties and excise taxes on intermediate goods led to a cascading effect of taxation on output prices. This heavily affected domestic producers and made it easier for the foreign exporters to enter the home market negating the comparative advantage of the country. Differential effective tax rates on final output of different sectors confounded policy intentions and production choices.

The base of personal income tax, which is potentially the most capable of introducing progressivity in tax incidence, was eroded by a large number of exemptions. Cash house rent allowances, conveyance allowances and entertainment allowances were not included for tax purpose in the hands of the recipients. Income invested in approved areas was allowed as investment allowance upto one third of total income (an upward maximum ceiling of

Tk 200,000 was introduced subsequently), and, at the same time, its yield was (and still is) also tax exempt. Capital gains arising from these and other assets were also left out of the preview of taxation, provided these were reinvested in the same or other assets. Dividend from public limited companies in the hands of non-company share holders was also entirely exempt. These had not only eroded the tax base but also distorted equity.

The use of filing threshold system, which taxed the entire income if income exceeded the minimum exemption limit (say Tk 40,000), rather than the excess over the threshold as would be done under a conventional exemption method, had a negative impact on tax compliance and incentives. The tax rate was also badly structured. The existing system of investment allowances also offered no incentive at all to taxpayers.

The extensive use of tax holidays as the predominant fiscal incentive to companies involved significant loss of revenue. Apart from the taxes foregone on the income of tax holiday units, it was also used to siphon off profits from the taxable units. This, coupled with the generous allowances provided under the personal income tax, badly impaired revenue productivity.

It was in the backdrop of the above that the reforms were initiated for (1) securing a steady rise in the tax-GDP ratio, (2) providing necessary incentives for savings, investment and exports, (3) ensuring some progressivity in tax incidence and (4) strengthening existing administrative capacity. These objectives of increasing revenue productivity, without distorting equity and providing incentives, are to be achieved by (a) eliminating exemptions that eroded the tax-base and equity provisions in personal income taxation, and by replacing the tax holiday scheme by superior investment incentives schemes in company taxation; (b) a broad-based taxation on consumption by a shift, in the case of commodity taxation, away from inputs towards output taxation; and (c) by strengthening the National Board of Revenue and its field level units to improve tax administration and enforcement.

II. EXPERIENCE IN TAX REFORMS

Direct taxes

Removal or reduction of exemptions and tax-free allowances, which used to erode the tax base and effective tax rates, has been an important part of reform of the direct tax system. A significant reform introduced is the discontinuation of the exemption of capital gains in computing income. Previously, capital gains arising from transfer of buildings or lands were exempt if the proceeds were invested in the purchase of stocks and shares of a public limited company within one year from the date of sale and the stocks retained at least for 2 years; or were invested in the equity of a company registered under the Company Act for setting up an industry. Capital gains arising from transfer of capital assets of a firm to a company formed by restructuring the outgoing firm were exempt if the gains were invested in the equity of the new company. Similar exemptions were granted for buildings and land appurtenant thereto (used as residence for at least two years) if the gains were invested for the purchase of another house property for residence, or in the construction of a residential house within two years or in the acquisition of a capital asset of an industrial undertaking within two years. The reform provided for the inclusion of realized capital gains in total income irrespective of where and how the gains are invested if the initial

investment for the acquisition of the asset from which the capital gains arose were deducted as an investment allowance in any preceding year or years.

Since 1986, the cost of acquisition of a capital asset for purposes of calculating capital gains was taken to be the market price that existed at the time of transfer and not the original price at which the donor or transferer had acquired it. This was reversed in 1990 with the stipulation that the "cost of acquisition" for the computation of capital gains would be the original cost to the transferer.

Until the 1990/91 assessment year, dividend declared by a private limited company was exempt upto Tk 15,000 in the hands of a shareholder other than a company. In the case of dividend declared by a public limited company, the entire dividend in the hands of a shareholder, not being a company, was exempt. The public limited company for the purpose included those in which more than 50 per cent shares were held by the Government or which remained listed for dealings in a registered stock exchange during the income year. Under recent reforms the exemption in respect of private limited companies was withdrawn, and dividend from public limited companies exceeding Tk 30,000 has been made taxable in the hands of a non-company shareholder.

In addition to the withdrawal of exemptions, deduction of tax on dividend at source has been provided. Hitherto laws allowed deduction of tax at source on dividends received by non-resident shareholders only. Intercorporate dividend or dividends received by resident non-company shareholders could not be withheld at source. In 1991, deductions at the rate of 10 per cent for "non-company" shareholders and 15 per cent on intercorporate dividend were allowed. However, a shareholder on production of certificate from the concerned Deputy Commissioner of Taxes, will not suffer deductions on dividends from public limited companies upto Tk 30,000, which is tax exempt.

Tax withholding in several areas have been introduced with a view to increasing tax collection and containing tax evasion. The most important withholding taxes are from (a) bank interest, (b) imports and (c) sale proceeds of immovable capital assets. Avoidance of import taxes was a major loophole that the withholding taxes were designed to plug in to improve tax collections. Those assessees whose incomes are not liable to tax were exempt from deduction at source on production of an exemption certificate from the National Board of Revenue to that effect. The concession, however, is not available for interest on bank dep ·sits and on sale proceeds of immovable capital assets. In the case of bank deposits this was done to obviate the possibility of tax evasion by account splitting in different banks or in different names. Exemption of interest upto Tk 15,000 for non-company depositors was also withdrawn. The law however provides for a claim of refund within four years by depositors whose total income falls below the exemption limit.

No exemption from withholding taxes on the sale proceeds of capital asset was allowed in view of the fact that taxpayers were evading and avoiding payment of income and capital gains taxes on a large scale in the aftermath of a rapid escalation of property values in post-independence Bangladesh. Enforcement of the withholding taxes resulted in considerable increase in revenue collections from all three sources.

Many salaried employees in Bangladesh receive perquisites in the form of house rent, conveyance and entertainment allowances in cash or in kind. For cash house rent allowance, an employee was entitled to an exemption of upto Tk 2,500 per month, or half of his basic salary whichever was less. Where rent free accommodation was provided, 20 per cent for a furnished and 15 per cent for an unfurnished accommodation were added to salary income for tax purposes. Entertainment allowances upto Tk 4,200 were exempt. Similarly, cash conveyance allowances upto Tk 4,800 were also exempt. Under reforms introduced in 1991, exemption of entertainment allowances was completely withdrawn. The valuation of benefits of rent-free unfurnished accommodation were raised from 15 to 20 per cent and for furnished accommodation from 20 to 25 per cent for assessment of income for tax purposes. These inclusions of allowances in the tax base helped to eliminate a major loophole under personal income taxation.

A change from the "Filing threshold" method to "Conventional exemption" method was effected by the Finance Act of 1992. Under the "Filing threshold" system, which was in force during the period 1985 to 1991, tax liabilities of assessees became excessive since the entire income became tax liable once income exceeded minimum exemption limits. As a relief from excessive tax liabilities it was provided however that the tax liability in no case could exceed one third of the total income in excess of the exemption limit. The method was changed to "conventional exemption" under which the income exempted remains completely exempt and tax is charged at graduated rates on income exceeding the exemption limit. This change also necessitated a corresponding change in the method of calculating investment allowances and donations for tax exemption. Under the "filing threshold" method, the permissible investment allowances and donations were deducted from the total income in order to arrive at taxable income. It resulted in ambiguities concerning allowable deductions as investment allowances and donations. Under the reform the system of investment allowances was replaced by an investment credit at 15 per cent (donation was deleted from the list of exemptions) to be deducted from the tax payable.

In Bangladesh, an attempt was first made to introduce presumptive taxation of groups, such as those who do not maintain proper books of account for lack of ability or willfully, as early as in 1981, in efforts to bring under the tax net the "hard-to-tax" groups. The legislation for this purpose was riddled with many defects and the modality for enforcing the system was not properly worked out. The scheme was therefore dropped within two years of its introduction. This has been reintroduced as part of the overall reform programme recently in a different form. The revised scheme envisages that for any person, not being a company, deriving income from business or profession and not maintaining books of accounts, a deputy Commissioner of taxes (an officer who makes assessment and collection of taxes) can presume his total income and ask him to support by relevant documents and establish that the income so presumed in not correct. The concerned tax official, however, is enjoined by law to have sufficient material facts in his possession to support such presumption and also to require previous approval of his supervisory officer, namely, the Inspecting Joint Commissioner of Taxes.

Basically, there is not much of a difference between this type of presumptive assessment and the normal assessment where a taxpayer does not maintain books of accounts and derives income from business or profession. In normal circumstances also an officer would estimate total income on the basis of material facts gathered by him, where books of accounts are not

produced or where a taxpayer does not comply with notices relating to filling of return. In the case of presumptive assessment, however, an officer is encumbered with the additional responsibility of having to obtain the previous approval of his supervisory officer, not necessary in a normal assessment. The scheme is considered to have succeeded in enlisting new taxpayers and increasing revenue. Although presumptive taxation is often recommended to capture hard-to-tax groups in the tax net specially in developing countries, in view of its administrative complications and the need to avoid taxpayer grievances, the system deserve to be further studied.

With the promulgation of the Income Tax Ordinance in July 1984, which repealed the Income Tax Act of 1922, the highest marginal rate of tax for individuals and non-company juristic persons was reduced from 60 to 50 per cent with five different rates applied to five income brackets. To avoid an anomaly under the "Filing threshold" method then in force, under which a taxpayer's total income became subject to tax once income exceeded the minimum exemption limit, a rider clause provided that tax in no case could exceed one third of the income in excess of the exemption limit. The operation of this one third effective ceiling resulted in a loss of progressivity of tax rates. This built-in defect in the tax rate structure was removed and the progressivity in rates was restored following a switchover to the "Conventional exemption" method as discussed above.

The highest marginal tax rate was reduced in a series of gradual steps from 70 per cent in 1975/76 to 60 per cent in 1978/79, to 50 per cent in 1985/86, to 45 per cent in 1991/92, to 30 per cent in 1992/93, and to 25 per cent in 1993/94, with different rates only for four income brackets, the first one indicating the exemption limit. This drastic reduction in the rates was motivated by the desire to increase taxpayer compliance and of dissuading taxpayers from resorting to large scale evasion. The result produced so far does not suggest that the taxpayer compliance has improved or the number of the taxpayers has increased.

In the case of registered firms, the highest rate was reduced from 30 to 25 per cent with only four tax brackets in place of earlier six brackets. Thus for the first time in the history of income tax, the maximum marginal rate for registered firms and individuals became equal.

Prior to recent reform, company tax rates were restructured as follows:

(1)	Publicly traded industrial company	45 per cent
(2)	Not publicly traded industrial company	50 per cent
(3)	All other companies including banks and financial institutions	60 per cent

In order to qualify for treatment as publicly traded industrial company, originally as many as seven conditions were required to be fulfilled, of which the most important conditions were (a) at least 10 per cent dividend were to be declared and distributed to the shareholders, (b) at least 50 per cent of the paid up capital at the end of an accounting year was to be subscribed by shareholders other than the directors and sponsors of the company, and (c) average ownership of shares of the company was no less than 1 for each 20,000 taka of paid up capital. The rates of company taxes have been reduced further and the classification

of companies has been simplified only on the basis of public trading and non-trading companies.

The rates of company tax presently are as follows:

(a)	Publicly traded company	40 per cent
(b)	Not publicly traded company	45 per cent
(c)	Other companies	50 per cent

The tax rate for capital gains in respect of companies and Registered Firms has remained unchanged. In keeping with the maximum marginal rate for individuals the flat rate of tax applicable to non-company non-residents has also been reduced from 30 to 25 per cent.

Indirect taxes

Value added tax

In the area of indirect taxes, the introduction of the value added tax (VAT) with effect from 1 July 1991 was a far reaching step. Within a short span of time, VAT has moved from an incipient stage to become the most modern, efficient and revenue productive system of indirect taxation in Bangladesh in place of a complicated indirect tax system. The import based taxation on which the country relied heavily performed two related functions – revenue raising and protection to domestic industries. The accent on protection in the tariff structure was thought to have led to inefficiencies in production and to create an anti-export bias. Import based taxation which provided more than 40 per cent of the revenue, caused revenue to fluctuate with the conditions of the balance of payments and the import capacity. The excise taxation, with its very narrow base, multiplicity of tax rates and extensive exemptions, was also considered inadequate for revenue purposes. Besides, there was substantial cascading of tax effects in the absence of a tax credit mechanism.

The VAT removes cascading and enables any taxpayer to know the tax content in any product with a degree of certainty. The self policing and cross checking of VAT at different stages of collection act as deterrent against tax evasion. With no need for frequent change in tax policies, investors can take decisions in matters of investment and operate in a certain and stable tax environment.

The VAT in Bangladesh has been imposed at a single positive rate of 15 per cent with exports being zero rated. A single rate has both administrative and accounting advantages over the multiple rates which distort choices. Multiple rates could also give rise to the problems of classification and definition without necessarily easing the adverse distributional impact generally associated with the regressive nature of indirect taxes. To ease the burden on the poor section of society and on distributional considerations, food and agricultural products are exempted and supplementary duties are imposed on goods with high income elasticities of demand.

The VAT in Bangladesh has a much broader base than the taxes it has replaced. All goods, except those mentioned in the first schedule to the VAT Act, 1991, are liable to VAT. With regard to the services also, the VAT base is larger than the excises it has replaced. Since

consumption is the largest component of GDP, VAT revenue is expected to go up with GDP growth, thus increasing the flexibility and elasticity of the revenue system.

The consumption type VAT that has been introduced in Bangladesh as opposed to the income or product based taxation will be a tax on consumer goods only leaving out capital goods. This has been done to ensure neutrality with regard to the choice of production and production techniques. With regard to the international trade regime, the destination principle as opposed to the origin principle has been adopted, under which VAT is payable on all value added at home and abroad in respect of goods that have as their destination the consumers of Bangladesh. In this system, exports are zero-rated and imports are subject to tax. The destination principle is thus compatible with the consumption type of VAT and ensures neutral treatment of imported and domestic consumption with the application of same rates to both.

For a tax paying entity to determine its tax liability, the credit method has been adopted in Bangladesh. Under the credit method, instead of direct calculation of value added, the tax rate is applied to a component of value added after deducting taxes paid on a taxpayer's purchase as his inputs. The taxes paid on purchases are deducted to get the net tax payable. In the process, the tax liability is attached to the transactions and the invoices become important documentary evidence which can be subjected to proper audit. The exemptions and exclusions are to be kept at the minimum for maximizing the benefits from VAT. Exemptions, by causing erosion of the tax base, necessitate imposition of a higher rate to compensate for the loss of revenue and bring in cascading effects by disrupting the credit chains. Exemptions also necessitate extra record keeping to distinguish between the exempt and taxable sales.

As a matter of principle, exemptions are not justified except on overriding administrative expediency, encouragement to exports, or on equity grounds. These are provided for with a single positive rate of 15 per cent with exports being zero rated; on distributional grounds, food products are exempted and supplementary duties are levied on certain luxury items. In order to encourage industries with requirement of low capital investments, instead of VAT a "turnover tax" at the rate of 2 per cent is charged, where the annual turnover is less than Tk 750,000.

Customs duty

Traditionally, promotion of import substitution industries in the country provided the rationale for the high tariff structure. Panoplied with protection and assured of sheltered market, the import substitution industries that were set up in the country were concerned mainly with the quick return on capital. In the process not only efficiency was sacrificed, the necessity for qualitative improvement of the product was never felt. The largely closed economy insulated against imports has been found not conducive for development. The system had discouraged investment in export oriented industries and militated against an optimal and efficient utilization of resources.

While recognizing the need for protection against dumping of foreign goods at low prices and an enabling power to take countervailing measures, a reform programme to overhaul the country's customs duty structure was found necessary. Under the reform programme, the rate structure of customs duties has been considerably rationalized by lowering high rates,

and reducing the number of rates by compressing tariff bands, thus moderating the level of protection available to domestic industry. Some of the effects of tariff reforms on the rate structure of duties are schematically shown in table 6.

Clearly, the average rate of duty has been steadily declining since major restructuring of duty rates was undertaken in the 1992 financial year. A substantial reduction of dispersion in duty rates, as measured by the coefficient of variation, has occurred as the number of rates was progressively reduced from 18 in FY 1992 to 13 in FY 1993 to 11 in FY 1994. The compression of duty rates can be seen further from the reduction of the number of H.S. codes with duty rates of zero and above 100 per cent over the period. The dependence on import duties as source of revenue is declining as a result of the downward adjustment of rates of customs duty in many other developing countries where the role of import duty as a source of revenue is also being de-emphasized. The tax base represented by the volume of imports is however found to grow with the growth of per capita income.

The maximum rate of customs duty is 300 per cent with a minimum of 0 per cent. However, rates above 100 per cent apply only to a few commodities such as alcoholic beverages and cigarette paper. For all practical purposes, 100 per cent is the statutory maximum rate. Generally, the rates are applied on the following formula: basic raw materials – 15 per cent intermediate inputs – 30 per cent; final consumer goods 45 per cent. Rates above 45 per cent are applied mainly on grounds of protection, applied on the basis of specific recommendations of the Bangladesh Tariff Commission. Customs duty on imports of capital machinery for export oriented industries has been withdrawn, creating a favourable climate for investment in export oriented industries.

Table 6. Changes in the structure and rates of import duty, 1992-1994

		FY 1992	*FY 1993*	*FY 1994*
1.	Mean unweighted duty rate	57%	47%	36%
2.	Coefficient of variation of duty rate	72%	65%	62%
3.	Mean weighted duty rate	24%	23%	22%
4.	Number of duty rates	18	13	11
5.	Number of H.S. codes with duty rates above 100 per cent	264	46	17
6.	Number of H.S. codes with zero rate of duty	395	323	296
7.	Percentage of customs revenue realized from:			
	(a) Items with duty rate below 30 per cent	29.78%	24.07%	20.49%
	(b) Items with duty rate 30-60 per cent	49.95%	58.29%	61.51%
	(c) Items with duty rate above 60 per cent and not exceeding 100 per cent	17.06%	16.24%	16.74%
	(d) Items with duty rate above 100 per cent	3.21%	1.40%	1.26%

Source: M.Z. Hossain, *Issues in Domestic Resources Mobilisation.*

Reform in tax administration

Organization

While initiating tax reform programmes, the efficiency of the administrative machinery which will implement the reform needs to be seriously considered. If changes introduced by tax reform are not compatible with the administrative capacity, the intended results cannot be achieved. Enacting laws with intent of increasing revenue productivity or removing the inequity of the tax system would not be enough if the administration is incapable of implementing them owing to its own inadequacies arising out the lack of resources, skills, efficiency and integrity. The reforms themselves need to be carefully thought out and the intended results or impact as far as possible correctly foreseen in order not to impair the mutual trust between the taxpayers and the tax authorities, so very important for efficient collection of taxes.

The entire taxation process starting from the enactment of the law to the collection of taxes, whether by raising demand or through advance payment or withholding mechanisms, requires the tax administration to be both efficient and honest. Therefore, tax administration reform is as much necessary as it is necessary to reform the system, pattern and rate structure of taxes. Reform should aim at improving compliance on the part of taxpayers and efficiency on the part of officials. As a matter of fact, the improved efficiency of administration is often capable of achieving substantial net gains in revenue from the existing tax system without any reform.

In Bangladesh, the National Board of Revenue (NBR) is at the apex of the hierarchy of tax administration. It is headed by a Chairman who is also the Secretary of Internal Resources Division, Ministry of Finance. Before, the recent reorganization, the Board had four Members in charge of indirect taxes and two Members in charge of direct taxes. The Members come immediately after the Chairman in the hierarchy. One of the four Members of the indirect tax wing was in charge of Customs, one in charge of excise, one in charge of Administration and Development, and one in charge of Customs Appeal. One of the two Members for direct taxes handled tax policy formulation, administration of the income tax department, and inspection and audit, and the other held responsibilities for the scrutiny of the appellate orders for filing references to courts and matters relating tax holidays, surveys and tax evasions.

Besides the Directorate of Training, Inspection and Drawback, the Directorate of Intelligence and Investigation and the Controller of Valuation, the field level of organizations responsible for Custom and Excise administration are the Custom Houses and Collectorates. In all five Collectorates were located in Dhaka and Chittagong and Khulna. For direct taxes also, besides the Directorate of Inspection and Training and the Directorate of Complaints (Investigation), field level executive organizations consisted of one Senior Commissioner having jurisdiction all over Bangladesh for survey, search and seizure. Eight zonal commissioners are entrusted with the job of raising revenue through assessing officers designated as Deputy Commissioners. The works of Deputy Commissioner are supervised by Inspecting Joint Commissioners.

Understaffing has been a major problem with the organization of tax administration in Bangladesh. Shortage of assessing officers adversely affected both the quality and quantity

of assessment resulting in staggering numbers of pending cases and outstanding arrear demands. The number of Inspecting Joint Commissioners was also inadequate to pay proper attention to the quantity and quality of the assessment. The system also came to be easily abused. Assessing officers, for example, often found excuses to defer assessments of large revenue yielding company cases to the last moment before they would get barred by limitation, which would prevent the Joint Commissioner of Taxes from subjecting them to scrutiny when presented for approval. Other factors undermining morale and motivation were poor pay scales and outside interference with the administrative decision making process.

The all important work of inspection and training did not receive the required attention necessary for making the job of inspection and training more effective as it was beyond the capacity of a single individual (the member in charge) to discharge these two important functions. The work load of the two members was excessive for them to be able to give adequate attention to such important matters as evasion and avoidance; survey, search and seizure; cadre management; and more importantly, training and inspection.

To ease some of these constraints recently, two additional Members for direct taxes in the NBR have been appointed and the work load reallocated. The Directorate of Training and Inspection has been bifurcated into two, each headed by an officer of the rank of a Commissioner. Posts of four more zonal Commissioners have been created in Dhaka, where the maximum income tax revenue is collected. The strength of offices of Commissioners, Inspecting Joint Commissioners, and Deputy Commissioners in other areas has also been increased. This is expected to improve the work of supervision of the work of subordinate staff responsible for assessment and collection. To further streamline work of assessment and collection, officers have been assigned distinctly classified categories of file, such for salaried employees, companies and other businesses.

The appellate function was discharged so long by the Appellate Joint Commissioners, working under the Commissioner for administration. However, in anticipation of increase in the assessment work resulting from registration of more taxpayers, the number of appeals are also expected to rise. Besides, it was thought to be administratively more convenient and more reasonable to put the appeals relating to company cases to a group of more mature and competent officers. Posts of Commissioners (Appeal) and Appellate Joint Commissioners were therefore increased with a view to helping expeditious disposal of appeal cases and a more competent handling of usually more complex company cases. This in turn would help collection of taxes out of demands locked up in appeal and help raise collection of income tax.

To improve tax administration and contain evasion, it is considered necessary to move towards mechanization of manual procedures leading to computerization. Along with the introduction of national taxpayers identification numbers, this will help the tax authorities to store the information in the respective master file of each taxpayer. The information thus stored can be retrieved when necessary and can be passed on for cross verification. This will substantially reduce human error and help identification of evaders and potential taxpayers.

The process of computerization has been started in NBR and also in the field level organizations, such as the offices of Commissioners of taxes and the Customs and Excise Collectorates. Necessary training is being imparted to officers both at NBR and in the field levels. The information flow, along with introduction of taxpayer national identification

number that computerization will facilitate is expected to act as a great boost in matters of checking and as a deterrent to evasion of taxes.

Apart from inefficiencies that stem from ignorance of statutes, rules and regulations, personal integrity of officers and staff is a factor which is of vital importance for checking tax evasion and avoidance. Attractive salaries can dissuade people from resorting to corruption but a regular system of punishing the corrupt and the inefficient, and rewarding the honest and efficient is also necessary.

To increase efficiency, human resource development in tax departments is very important. Both extensive and intensive training is necessary for the new entrants and for those who are already in service. Laws are changing and new concepts are emerging. In order to keep abreast of the changes and their implications, intense training is a must. As a part of the reform programme, the Directorate of Inspection and Training for the direct taxes has been bifurcated. Each Directorate is now headed by an officer of the rank and status of a Commissioner. Newly inducted officers are imparted training for a period varying between 6 months to 1 year. Besides, the officers already on the job are also given periodic training, though not on a systematic and regular basis. However, training is limited to the level of assessing officers only. Supervisory officials, who monitor the assessment and collection work of the assessing officers, are not given any training or reorientation courses. In view of the importance of their supervisory work they also need training to update knowledge in both theory and practice.

Legal sanctions and penalties

Under the existing provisions of income tax administration, monetary penalty can be imposed for: (i) not maintaining accounts in the prescribed manner, (ii) not filing tax return in time with additional penalty for continuing default, (iii) failure to pay advance tax, (iv) non-compliance with notices, (v) failure to pay tax on the basis of return and (vi) concealment of income. In the case of concealment of income, considered to be the most serious offence, penalty is as high as two and half times of the income sought to be evaded. In the case of an assessee availing of the opportunity under self assessment, the maximum imposable penalty for concealment is five times of the income sought to be evaded. If those who are authorized to deduct and collect tax at source and deposit them to the Government account within the stipulated period, fail in their obligations, they will be deemed to be an assessee in default and will have to pay a penalty at 2.5 per cent of collection due for the period of default.

Other than monetary penalty, attachment of properties and garnishment of funds due from other persons can also be made for realization of taxes. Prosecution can also be started for non-compliance with certain obligations, concealment of income, and sale of property to escape attachment.

Non-compliance with VAT formalities like registration, tax payment, maintenance of accounts, non-issue of tax invoice, and of non-payment of taxes are treated as offences and are liable to penal action. The offended goods along with their carriers are subject to seizure and confiscation. The VAT officials can impose penalty on the VAT registered firms also. However, any person aggrieved by any decision of a VAT authority can appeal to the next higher authority for redress.

Thus, enforcement rules in both the Income Tax Ordinance and the Statute for VAT are quite formidable. Their judicious invocation in appropriate cases remains a vital task for an efficient and honest system of tax administration.

Taxpayers compliance and education

Tax administration reform, among other things, should aim to improve compliance on the part of the taxpayer. Several reasons can be attributed to the poor compliance on the part of the taxpayers. One of them is the complexity of tax laws. Since most of the taxpayers are not sufficiently educated to fully realize the provisions of tax laws, unscrupulous tax lawyers exploit the situation to their advantage. The poor taxpayer does part with money but not as taxes going to the government coffer but often as kickbacks. There is also an innate lurking fear working in the minds of a new taxpayer that once his name is on the tax register, he will be required to pay taxes and kickbacks even when he suffers losses or discontinues income earning activities, or subjected to harassment. High tax rates were often held responsible for non-compliance. Even after the reduction of tax rates the problem seems to continue.

Taxpayers education to create a mutual trust between the taxpayers and the tax officials is imperative, an aspect which has been generally ignored. The tax department directly or through chambers of commerce and the media could educate taxpayers so as to make them conscious of their responsibilities to society and to the state, and to allay the fears, genuine or otherwise, from their minds.

Survey work undertaken periodically by the Department to seek out the tax dodgers very often fail to produce tangible results. Such failures tarnish the image of the department as well as emboldens the dodgers to evade the tax net. Survey and collation work, along with taxpayers education, should be synchronized and orchestrated so that taxpayers will readily pay without fear of being harassed, and dodgers will learn that non-compliance will cost them more.

III. TAXATION, REDISTRIBUTION AND GROWTH

Growth orientation of tax policies

Despite many limitations, taxation remains an effective tool for domestic resource mobilization for accelerated economic growth, improved distributional equity and the alleviation of poverty. Over the years, though government revenue from taxes increased along with the growth of national income, revenue increase did not keep pace with the growth in government expenditure. Tax revenue in Bangladesh lacked elasticity and buoyancy and generally did not respond well to changes in income.

Taxes are classified into indirect and direct taxes. Although the share of indirect taxes have been declining, the country still remains overly dependent on indirect taxes. Indirect taxes in Bangladesh, with relatively low levels of per capita income, will have a place in reaching the broadest sections of population for revenue generation. Indirect taxes however tend to distort allocation of resources by changing the relative prices of commodities. Its incidence also tends to be regressive. Direct taxes, by contrast, are supposed not to distort relative prices and are, therefore, considered neutral for resource allocation.

Sectoral distribution of the overall weight of taxation would however still have significant effects on resource allocations. Capital in the private sector would tend to concentrate in sectors where overall tax weights are lower and return on capital quicker than in others. In the past, capital tended to move to industries protected by high tariffs. Administrative bans and quantitative restrictions were also imposed to protect industries and resources moved into the protected industries. Returns on capital in those industries were also quick; and they were highly profitable from the private entrepreneur's point of view. They did not however reflect optimal and efficient utilization of resources. It is now apparent from the experience of a number of countries that such policies retarded overall economic development, and opened up opportunities for "rent seeking" at the cost of the consumers. Bangladesh therefore has opted for an export oriented development strategy.

Elimination of customs duties and VAT on imported capital machinery for export oriented industries, zero rating of export for the purpose of VAT, and duty drawback on imports of export industries, are all elements of policy pursuant to that strategy, and have encouraged setting up of export-oriented industries. Capital moved towards export industries in recent years and export earnings have gone up.

"Cottage industry" enjoys exemption of VAT. Industries where the annual turnover is less than Tk 1.5 million and have machinery worth less than Tk 300,000 at any time of the year are treated as cottage industries. The industries with an annual turnover of less than Tk 750,000 are also exempted from VAT and subjected to a turnover tax of only 2 per cent. These provisions for low rate of "turnover tax" in lieu of VAT and exemption of "cottage industries" from VAT will definitely encourage labour intensive industries. Resources are expected to move to these areas and encourage employment in small scale industries.

In direct tax policy, "tax holiday" and "accelerated depreciation" were used for accelerated industrialization and geographical dispersal of industries. Under tax holiday, industries newly set up were entitled to total tax amnesty for 5, 7, 9 and 12 years depending upon its location. The scheme was first introduced in Pakistan in 1959 and was abandoned immediately after the emergence of Bangladesh, but was reintroduced again in 1974.

Although capital and resources moved in desired directions, the system was grossly misused. Once the tax holiday period expired irrespective of its length (5, 7, 9 or 12 years), the industry enjoying total tax amnesty in most cases would show losses. Besides, this was used to lower profits of non-tax holiday units by siphoning off expenditures pertaining to tax holiday units to non-tax holiday units, and thus reduce the tax payable. With the expiry of the tax holiday period, these industries reported falling "sick", failing even to repay loans and interest accrued on them. Banks had to be allowed to write-off these as bad debts for purposes of tax assessment on them. This had seriously impaired revenue productivity. It may, however, be mentioned that this "default culture" was not peculiar to loans advanced to tax holiday industries. It encompassed both tax holiday and non-tax holiday cases as a typical scenario in recent years in Bangladesh.

A study was commissioned to evaluate whether the tax holiday schemes were viable and how far they have helped in the process of industrialization. The findings were not conclusive. The fact remained however, that they have definite distorting effects on resource allocation.

To encourage resources to move to agro-based industries in rural areas to help generate income and employment of the middle income and poor people, income derived from fisheries, cattle raising, poultry, dairy and frog farming, horticulture, mulberry, sericulture cocoons and mushroom cultivations have been completely exempted from income tax upto 2000 A.D. These labour intensive activities will help "growth with equity". No conditions were imposed initially either for obtaining these benefits and retaining them subsequently. A condition has been imposed subsequently requiring any person deriving income from these activities to invest 10 per cent of the profit exceeding Tk 100,000 as a minimum check on tax evasion.

Along with zero rating of export oriented industry for VAT and exemption of customs duty on the import of capital machinery for them, income tax rebate at the rate of 50 per cent of the tax attributable to profit from export sales has been allowed. Besides, income from the industries set up in the export processing zones has been exempted from tax for ten years from the start of commercial production. After the expiry of ten years, 50 per cent of the profit attributed to export will remain exempt. The income from the export of handicrafts is entirely exempt from income tax. The cumulative effects of these provisions have already given a tremendous impetus to export oriented industries.

In order to facilitate the flow of foreign investment in industries in Bangladesh, the interest payable on moneys borrowed outside Bangladesh in the following cases has been exempted for tax purposes:

(i) Moneys borrowed outside Bangladesh by an industrial undertaking in Bangladesh under a loan agreement entered into with any such financial institutions as may be approved.

(ii) Moneys borrowed outside Bangladesh by an industrial undertaking in Bangladesh for the purchase of capital plants and machinery outside Bangladesh.

(iii) Moneys borrowed from sources outside Bangladesh by the Bangladesh Shilpa Rin Sangstha or Bangladesh Shilpa Bank or the Investment Corporation of Bangladesh.

(iv) Moneys borrowed from outside Bangladesh by any other financial institution established in Bangladesh or a Bank to which the Banking Companies Ordinance 1962 applies, for the purpose of advancing loans to an industrial undertakings in Bangladesh for purchase outside of Bangladesh of raw materials or capital plant and machinery.

(v) Moneys borrowed from sources outside Bangladesh by any leasing company established in Bangladesh and approved by the National Board of Revenue. The dividend paid by a leasing company established in Bangladesh and approved by the National Board of Revenue to the foreign shareholders is also exempt from income tax.

Dividend income of any non-resident shareholders of a company from industries set up in an Export Processing Zone is also exempt in its entirety for the period for which the industry enjoys tax exemption, and also after the expiry of the tax exemption period provided the dividend income is reinvested in the same project. Any royalties or fees received by a foreign collaborator, firm, company or expert is also exempt from tax for the above mentioned purpose.

Income from "cottage industry" is also exempt from income tax. The definition of Cottage Industry. in the Income Tax Ordinance is different from that under the statute on VAT but the purpose of the exemption is the same i.e. to help generate income, and self-employment of poorer sections with small capital investments.

Under the Income Tax Ordinance cottage industry means an enterprise not being owned by a Joint Stock Company and fulfilling the following conditions: (i) it is an enterprise in which the owner is the investor, a full time worker and the actual entrepreneur; (ii) the capital investment in plant and machinery does not exceed 100,000 taka at any time during the income year; (iii) the number of workers including family members does not exceed 15 on any one twenty-four hour day during the income year; (iv) the owner or any member of his family does not own any other industrial or commercial enterprise either in his own name or in the name of any other person.

The entire income of any cooperative society, if it is engaged in agriculture or rural credit, and marketing of agricultural produce of its members, is exempt. Income from interest and dividend derived from its investments with any other cooperative society is also exempt.

Reforms in both direct and indirect taxes have thus been, by and large, geared to encourage savings, investment, exports, employment and economic growth without sacrificing the productivity of the tax system. The above description of the incentive structure built into tax bases and rates clearly indicate such a stance of policy. The time period for which the reforms have worked is still too short to produce conclusive statistical evidence of the impact of reforms. Nor can all changes in macroeconomic data be attributed to changes in tax policies and measures. Nevertheless, the rise in tax-GDP ratio, the savings rates and exports in years for which latest data became available indicated a measure of success of the reforms. Although the investment rate was yet to pick up, a firming of the economy's growth rate in the region of 4-5 per cent and a rise in the proportion of domestic resources financing the Government's annual development programmes, provided further evidence of success.

Tax policy and equity

An argument against VAT is that it is regressive and inequitable. The taxes that it has replaced were however no less regressive. With a view to making it less regressive and from the point of view of income distribution, lower rates are required to be applied on goods which are consumed by poorer people and higher rates on goods consumed by richer people. This is likely however to reintroduce the undesirable features of the taxes it replaces including the administrative complications. A workable compromise has been therefore made by exempting certain goods like unprocessed food items and charging supplementary duties on luxury items.

Reforms have removed several prevailing inequitable features of he direct tax measures. Under the filing threshold method in force upto 1991, a taxpayer's entire income was subjected tax once income exceeded the minimum exemption limit. Although a rider clause stipulated that total tax liability could not exceed one third of the total income excluding the permissible investment allowances and donations, the system imposed unfair tax burden particularly on those whose incomes barely exceeded the exemption limit. It encouraged people to understate incomes as income tended to rise above the exemption limit. These features made the income tax highly inequitable and distorted its distributional impact. With the conversion to conventional exemption method, this distributional problem has been removed.

The inclusion of the monetary value of employment related perquisites of entertainment and housing allowances has widened the tax base by bringing in more of the better paid employees under the tax net. The exemption limit however has been raised further to ensure no undue hardships are imposed on low-income earners.

Total withdrawal of exemption of dividends from private companies and limiting the exemption of dividends received from public limited companies to Tk 30,000 only in place of total exemption also has made the income tax system more equitable. Exemption of interest on bank deposit upto Tk 15,000 was also withdrawn.

By a widening of tax withholding at source on bank interest, imports and on the sale of immovable assets, substantial increase in revenues could be made. Widespread evasion of taxes on these accounts occurred through falsification and fraud. A withholding tax of 10 per cent has contained evasion to a point, if not eliminated it altogether. Tax evasion caused serious social injustices by increasing disparities between those who can evade and avoid taxes and those who cannot.

IV. CONCLUSIONS

The UNDP Human Development Index of 1993 ranked Bangladesh at 147th among 173 countries. The country has to be lifted off the least develop country status, for which gross investment of at least 17-19 per cent of GDP is necessary to achieve sustained growth rates of 6-7 per cent as a means of poverty alleviation. Estimates place 40 to 50 per cent of the people below the poverty line, defined in terms of either a calorie norm or an income norm. Associated problems of health and nutrition, education, housing and sanitation are staggering. Without the safety nets consisting of the Food for Work Programme and the Vulnerable Group Feeding programmes, poverty would have been worse.

Poverty alleviation is thus a colossal problem in Bangladesh and it cannot be solved easily and quickly. The best way to reduce poverty in a sustained manner is to create additional jobs, make credit facilities available to the poor which in turn will create opportunities for self employment, develop human resources, and also build infrastructure facilities, activities which can simultaneously contribute to growth, equity and poverty alleviation.

The mobilization of internal resources to the fullest possible extent, and in that context realization of taxes and increasing revenue productivity, assume great importance. The tax reforms carried out in Bangladesh during the recent 3-4 years have shown significant increase in revenue productivity enabling increased allocations of revenue surpluses to the Annual Development Programmes.

As a result of tariff liberalization, custom duties which accounted for 34 per cent of tax revenue in the 1993 fiscal year, are expected to fall further. Collection from income tax and VAT should therefore become more important.

The contribution of income tax to the national exchequer could still be substantially increased, if certain problems relating to widening the tax base by further shortening of the long list of exemptions in personal income taxation in view of the drastic reduction of tax rates, are properly addressed. In company taxation, further changes are desirable both on revenue

and equity grounds. The tax rates of different taxable entities and the distortion they have caused in the equity and distributional situation need also to be looked into. Lastly, the problem of tax evasion and avoidance, causing huge loss of revenue and distorting its equity, should also be effectively dealt with.

The scheme of tax holiday, originally introduced in 1959 in Pakistan, was jettisoned by Pakistan sometime after 197 for its failure to produce the desired result of industrial dispersal and accelerating the process of industrialization. Although it was also discontinued in Bangladesh in 1972, it was reintroduced in 1974. This scheme was to have ended on 30 June 1990 but it was extended in 1988 in advance of that expiry date to 2000 A.D. Rough and ready calculation indicates an 8 to 10 per cent loss of revenue from the corporate sector, owing to the tax holiday exemptions.

The system is being grossly misused; the units enjoying tax holiday start reporting losses once the tax holiday period expires with no plausible reason existing for such losses to suddenly appear after 5 to 12 year periods of tax holiday. Besides, it has also not helped in industrial dispersal as most of the industries approved for tax holiday over the past years will be found to have been set up in and around Dhaka, Chittagong and Khulna despite greater incentives for setting up industries in other places.

An important reform measure was the inclusion of realized capital gains in the income base. The "cost of acquisition" for the computation of capital gains was stipulated in 1990 as the original cost rather than the current market price at the time of transfer is made. This was a step in the right direction. However, the cost of acquisition of capital assets was again being reversed to the pre-1990 method of valuation at current market prices. The wisdom of doing so was not clear. The gift tax, abolished in 1985, was reintroduced in 1990, gift made by father, son and spouse etc. amongst themselves being exempt.

Until 1992, capital gains arising out of sale of shares and stocks of a public limited companies were exempt, if they were reinvested in the purchase of shares and stocks of another public limited company and retained at least for two years. This condition for retention has been withdrawn. However, there is no law for forcing any company to declare dividend or for charging additional tax on undistributed profit. The issuance of bonus share and/or bonus to a shareholder also is not considered to be dividend. In these circumstances, Government exchequer is deprived of the tax on dividend and on capital gains for share transfers.

Interest credited to Provident Fund of an employee was previously included in total salary. This interest has now been taken out in calculating total income. This exclusion could take a taxpayer's income below the exemption limit and take him out of the tax register owing to a lowing of taxable incomes. Since the interest on bank deposits and other interests are taxed without any exemption, the total exemption of the interest credited to Provident Fund is not equitable.

The wide differences between the company tax rates (40, 45 and 50 per cent) and the maximum marginal rate for personal income tax (25 per cent) should be minimized so as to prevent the tax induced movement between personal income, partnerships incomes, and company incomes. Companies can lower their tax liabilities by increasing the salaries of employees or by transferring ownership of assets to individuals. Although it is difficult to avoid

such arbitrage completely, keeping corporate tax and personal income tax rates closer can substantially reduce it.

The exemption of 30,000 taka in the hands of shareholders of pubic limited companies (other than corporate shareholders) does not seem to be fair. In order to earn Tk 30,000 as dividend, one must invest Tk 300,000 to Tk 350,000 at the rates of dividend payments generally observed at the present. In a country where per capita income is so low, such an exemption to relatively wealthy investors, may lack justification. This is particularly so in the context of total withdrawal of exemptions to bank interest which is subject to withholding tax irrespective of the amount of interest earned and which may hurt small depositors.

For investments in government securities, an investor gets the benefits of the investment allowance and also tax free yields. Taxation of dividends in that respect militates against the interests of company shareholders as a result of which investment in the private sector may suffer. There is also an element of double taxation of dividend since share holders are not allowed a tax credit for the tax paid on the dividend by the hands of the company before distribution. However, in the absence of compulsory provision in law to force companies to declare dividends (such a provision existed in the repealed Income Tax Act), or for treating bonus shares as dividend, companies prefer not to declare or to declare bonus share instead to save their share holders from tax liabilities. These matters need further consideration.

Containment of the present large scale evasion and avoidance of taxes should be properly addressed. A change in the present system of assessment may help in this. The present practice of calling for all income tax returns (except salary and self-assessment returns) and the assessees to appear before the assessing officers for examination of all books of accounts and papers is an antiquated one. The system has resulted in harassment of the taxpayers, accusations of corruption and accumulation of unrealized demands. The present system of assessment should be dispensed with and all returns filed by the assessees should be accepted without scrutiny.

Samples of the returns however may be subjected to occasional checks. Suspicion of concealment of income, relatively large investments, reduced income from the last assessed income, reputation of the assessee, information from extraneous sources, and the accretion in assets not commensurate or compatible with the disclosed income may be used as criteria for the sample checks.

As for the indirect taxes, VAT at present is charged only on the importers and manufacturers. Since VAT is designed to tax output instead of input, the logic of the scheme demands its extension to wholesale, and finally, to the retail sales. Besides the administrative problems, resistance from the business and trade community will pose a problem. The extension therefore may be phased out, choosing a few items to start with and then gradually rolling on.

Bangladesh has been making serious efforts to strike a balance between the objectives of growth and equity while implementing structural adjustment programmes. The dual objectives can be achieved by increasing investment by maximizing internal resource mobilization. Maximization of the revenue productivity of taxes would help in achieving these objectives. The reforms introduced in the country's tax system are moves in the right direction although scope exists for further fine tuning of the system.

INDIA

I. SALIENT FEATURES OF THE TAX SYSTEM

General characteristics

The Indian tax system share the characteristics of the tax system of a typical developing country. The tax structure has had a predominance of indirect taxes, consisting mainly of customs and excise duties. Although India has one of the longest history among developing countries of having introduced the income, corporation, wealth and gift taxes, the relative contribution of direct taxes to government revenue has remained small. A major reason for this relatively low contribution of direct taxation to revenue has been attributed to the exclusion of agricultural income from the purview of income taxation for some historical reasons. The relative share of direct taxes to government revenue has, in fact, declined and dependence on indirect taxes increased during the 1980s.

India's fiscal structure is of a federal character, in which the jurisdiction of tax powers are divided constitutionally between the union government of India and the various states. The income and other direct taxes (other than on agricultural income and wealth) as well as customs duties are administered by the union government. The sales tax is the exclusive jurisdiction of the state governments. The excise duties are levied both by the union and the state governments on different sets of commodities. Apart from the usual problems associated with an overdependence on indirect taxation for government revenue, the federal structure of the Indian tax system results in some additional complications for the running of a streamlined tax and revenue system.

India has, nevertheless, made attempts from time to time to reform and streamline its tax system. From a historical prospective, several such attempts can be cataloged since independence, starting with the first major attempt made in 1953. These efforts sought to address issues and resolve problems as they appeared important at the time. The overall results, however, did not quite succeed in designing a tax system that could be considered productive in terms of its revenue responsiveness to changing income levels in the country, or in ensuring efficiency and equity.

In 1991, India launched a programme of major reforms in its tax system as a key component of structural reform of the economy. A major aim of the reform has been to improve the revenue productivity of the tax system, with a view to reducing government borrowings to finance its expenditure programmes. At the same time, the aim has been to ensure that taxation does not act as a source of inefficiency in the allocation and use of resources. Equity consideration has also figured importantly but the accent has been on efficiency and incentive for work, savings and investment. The goals of poverty alleviation and promotion of equity are better served by appropriate government expenditure programmes for which the tax system should be able to generate sufficient revenue.

Growth and composition of tax revenue

In 1985/86, India raised 16.5 per cent of GDP in tax revenues, which compared favourably with the tax-GDP ratio recorded in countries at comparable levels of per capita income. The share of revenue in GDP in India advanced significantly from 11 per cent in 1970/71 to 16.5 per cent in 1985/86. This was also reflected in a rise in the incidence of per capita tax of the Indian population from Rs 86 in 1970/71 to Rs 161 in 1985/86 at constant 1970/71 rupee value. No further progress was made since then in raising the tax-GDP ratio which remained at the same 16.5 per cent level in 1990/91 as in 1985/86.

At least four fifths of tax revenue in India are raised from indirect taxes. That makes India's dependence on indirect taxes greater than in many other developing countries. Moreover, contrary to observed trends in many other developing countries, the share of indirect taxes in total tax revenue in India went on increasing. Thus the share of indirect taxes in revenue went up from about 79 per cent in 1970/71 to 86 per cent in 1990/91 (table 1). Correspondingly the share of direct taxes declined from 21 per cent in 1970/71 to 14 per cent in 1990/91. This decline in the share of direct taxes is also contrary to expectations that revenue from direct taxes would prove more elastic in relation to changes in the income levels in the country and increase its share in total revenue.

A corollary is a growing dependence on foreign trade taxes. As a country grows and develops, dependence on international trade taxes generally declines. In the case of India, however, the dependence on foreign trade taxes, mainly in the form of customs duties on imports, increased overtime. Customs duties contributed 23.5 per cent of revenue in 1990/91 compared with 11 per cent in 1970/71. The share of indirect taxes raised on domestic production and sales correspondingly declined. The Union excise duty, and the sales tax administered by the states, are major domestic taxes and accounted for more than half of the total tax revenue in 1990/91 (table 1).

Table 1. Composition of tax revenue
(Percentage)

	1970/71	*1975/76*	*1980/81*	*1985/86*	*1990/91*	*1991/92*
Direct taxes of which:	21.3	22.3	16.4	14.4	14.0	15.8
Corporation tax	7.8	7.7	6.6	6.6	6.1	7.1
Individual income tax	10.0	10.9	7.6	5.8	6.1	6.6
Agricultural taxes	2.8	2.3	1.0	1.1	0.9	0.8
Others direct taxes	0.7	1.4	1.2	0.9	0.9	1.3
Indirect taxes of which:	78.7	77.3	83.6	85.6	86.0	84.2
Customs duties	11.0	12.7	17.2	22.0	23.5	22.3
Union excise duties	37.0	34.4	32.8	29.9	27.9	27.0
Sales tax	16.6	17.7	20.3	20.2	20.8	21.3
State excise duty	4.1	3.9	4.2	4.8	5.7	5.5
Other indirect taxes	10.0	8.9	9.1	8.6	8.1	8.0
Total tax revenue	100.0	100.0	100.0	100.0	100.0	100.0
Total revenue as percentage of GDP	11.0	14.2	14.6	16.5	16.5	16.8

The individual income tax and company taxes contribute almost equally to total direct tax revenue. The overall decline in the share of direct tax in total revenue reflects a relative decline in both these two major sources of direct tax revenue. Thus the share of individual income tax in total revenue fell from 10 per cent in 1970/71 to 6.1 per cent in 1990/91 while the share of corporation tax declined from 7.8 per cent in 1970/71 to 6.1 per cent in 1990/91. Taxes on agriculture in the form of land revenue and a supplementary income tax in some of the states are administered by the state governments. Since the land revenue was a significantly charge on agricultural income when the income tax was first introduced in India, agricultural income was excluded from the purview of the income tax and has remained excluded since then. However, the significance of land revenue both as a proportion of income generated in agriculture and in total tax revenue has declined and, along with supplementary income taxes introduced in some of the states, currently agricultural taxes contributed less than 1 per cent of total tax revenue.

Table 2 provides measures of growth of revenue from various taxes and their buoyancy and elasticity. True to the characteristics described above, the growth, buoyancy and elasticity measures confirm (though these measures may be flawed in many ways) the slower rates of growth of revenue from direct taxes overtime. Thus, the annual rate of growth of direct tax revenue was 13.5 per cent during the period 1980/81 to 1991/92 compared with a growth rate of 16 per cent in indirect tax revenue. In terms of buoyancy measure, indirect taxes with a coefficient of 1.12 indicated a higher degree of responsiveness compared to direct taxes with a coefficient of 1.00 during the above-mentioned period. In terms of elasticity measure, the elasticity coefficient fell below 1 both in the case of direct and indirect taxes and, consequently, for the tax system as a whole.

Table 2. Growth, buoyancy and elasticity of tax revenue, 1980/81 to 1991/92

	Growth rate (per cent per year)	*Buoyancy*	*Elasticity*
Direct taxes of which:	13.5	1.00	0.80
Corporation tax	13.2	0.97	0.69
Individual income tax	15.0	1.11	1.22
Agricultural tax	12.2	0.95	0.82
Others direct taxes	8.3	0.67	0.30
Indirect taxes of which:	16.2	1.12	0.98
Customs duties	20.1	1.33	1.10
Union excise duties	13.8	1.00	0.88
Sales taxes	16.0	1.11	0.97
State excise duties	18.4	1.23	1.15
Other indirect taxes	14.5	1.02	0.90
Total taxes	15.7	1.10	0.97

Note: Growth rates have been estimated using semi-log trend equation. Buoyancy and elasticity estimates have been obtained by regressing total tax revenues and tax revenues excluding the effect of discretionary measures respectively on GDP in a log-linear equation. All the estimates are significant at 1 per cent level.

The elasticity measure indicates that the automatic response of the tax system in generating revenue has been tardy and has tended to exert a downward pressure on the tax-GDP ratio. The growth in tax revenue and a rise in overall tax GDP ratio are thus the result of discretionary changes introduced into the tax system from time to time as captured in the measure of buoyancy. Thus, in short, the Indian tax system has been characterized by relatively low revenue productivity, declining importance of direct taxes, a growing reliance on import duties as a source of revenue, and uncertainty created by frequent discretionary changes in tax measures.

Basic weaknesses of the tax system

Narrow tax bases

The existence of a large segment of unorganized economy, a weak information base, and operation of powerful "distributional coalitions",[1] have caused the tax base to be narrow in respect of both direct and indirect taxes. In the case of personal income tax, the non-inclusion of the agricultural incomes in the tax base leaves almost 30 per cent of incomes out of the tax net altogether,[2] and administrative difficulties make it difficult to extend taxation to incomes generated in the unorganized sector. Even within the organized sector, exemptions and deductions for various purposes and payments of income in-kind as perquisites provide a large avenue for tax avoidance; in the absence of a well organized information system, it has been difficult to levy taxes on the usually "hard-to-tax" groups. In the event, the extent of tax evasion has been large and growing over the years.[3]

In the case of corporate entities, the generous deduction allowed for depreciation and for a wide variety of "social" purposes exclude a sizeable portion of their earnings from the corporation tax base. Similarly, indirect taxes are confined mainly to manufactured commodities, and only recently, some selected services have been brought within the purview of taxation. In the case of general sales taxes, leviable by the States, the gradual shift towards the first point levy, ostensibly for administrative convenience, has left the entire value-added at stages subsequent to manufacturing or import into a State out of the tax net. In addition to these, the "non-representative" coalitions are able to take advantage of legal loopholes and the judicial system to further erode the tax base.[4]

Complicated tax structure

For several reasons, the Indian tax structure has become unduly complicated. The traditional emphasis on vertical equity – of "levelling down" the incomes of the rich – has led

[1] "Distributional coalition" is taken to mean narrow special interest groups having disproportionate organizational power for collective action to serve a common self-interest. See M. Olson, *The Rise and Decline of Nations* (Yale University Press, 1982).

[2] The Constitution assigns the right to levy agricultural income tax to the States but the powerful farm lobby has succeeded in keeping farm income out of the tax net.

[3] Shankar Acharya and Associates, *Aspects of the Black Economy* (New Delhi, National Institute of Public Finance and Policy, 1986).

[4] The rent control laws and the judgements in favour of taking controlled rent to determine rental value for property tax purposes when the actual rent is higher illustrate the point.

to minute rate differentiation in both direct and indirect taxes on the basis of policy makers' judgements on welfare levels across income classes and consumption patterns. Also, tax policy has been employed as a tool to fulfill a host of other objectives, such as to encourage savings, promote investment in the "desired" industries, maximize employment (through concessions to the small scale sector), promote interregional equity (through differentiated tax concessions across regions) and promote several other social objectives. Commodity tax rates are differentiated on the basis of perceived judgements about income elasticity of demand for commodities. The politics of tax evasion and avoidance and attempts to secure tax exemptions and concessions by politically powerful groups have added to the complexity.

Distortionary taxes

The pressure to finance ever increasing consumption and investment requirements of the public sector has placed undue emphasis on raising revenue ignoring the distortionary effects of the levies. Given that the tax bases are narrow, revenue requirements necessitated the levy of taxes at high rates in respect of both direct and indirect taxes. The emphasis on vertical equity led at times to confiscatory levels of high marginal tax rates in the case of personal income tax with severe disincentive effects on work effort, savings and investment. A clear instance of raising revenues disregarding the economic consequences is the use of import duties as a source of revenue rather than a protective instrument. Similarly, at the State level, the levy of sales tax on inter-State trade did not take note of the adverse economic consequences it gave rise to. Likewise, raising tax revenue from administratively convenient points has resulted in imposing commodity taxation on inputs, outputs and capital goods alike at Central, State and even local levels and thus has severely distorted the tax structure.

Federalism and tax policy

The Constitution of India in its Seventh Schedule assigns tax powers to Central and State governments. Accordingly, the major direct taxes, namely, the taxes on non-agricultural personal incomes, company profits and the non-agricultural wealth and gift taxes are assigned to the Central government. The States have been given the right to levy land revenue, taxes on agricultural incomes and wealth as well as taxes on professions, trade, callings and employment and on property. Among the indirect taxes, the Central government has been assigned the right to levy customs, manufacturing excises on all commodities except liquor and intoxicants. The States can levy the sales tax, excise duty on intoxicants and liquor, taxes on motor vehicles and the goods and passengers carried by them, on the transfer of property (stamp duties and registration fees), on entertainment, electricity duty, and taxes on the entry of goods into a local area for consumption, use or sale (octroi). The Constitution also provides for the sharing of revenues from taxes on non-corporate income tax and Union excise duties between the Centre and the States based on the recommendations of the Finance Commissions reporting from time to time. Of the taxes assigned to the States, property taxes and octroi have been passed on to the local bodies and in some States, the levy of the tax on professions and entertainment is also assigned to them.

In addition to the issues usually faced in developing countries in framing tax designs, the fiscal decentralization in a federal polity has been an additional source of distortion and inequity. The Constitutional arrangement of tax devolution is suspected to have created a structure of disincentives on the tax system itself in terms of efforts exerted by governments

at different levels. As the overwhelming proportions of revenue from personal income tax and Union excise duties are transferred to the States on the recommendations of Finance Commissions, it is suspected, for example, that the Centre has tended to concentrate on non-sharable revenue sources such as customs duty and the in administered prices to raise revenues.[5] On the other hand, the States looked more towards shared revenue rather than exerting their own authority and power to tax. As a result import duty came to be treated more as a source of revenue for the Centre than a protective instrument; and administered prices of public monopolies tended to get out of line with the excise duty structure as the Centre tended to use those prices to raise more revenues. The relative prices got distorted as a result.

The vertical overlapping of commodity taxes brings in non-transparency and complexity on the tax system. The independent tax systems prevailing at different levels often work at cross purposes and render the overall achievement of macroeconomic objectives difficult. In addition, horizontal tax competition among sub-Central units and inter-jurisdictional tax exportation has been another source of distortion in the tax structure of the Central as well as sub-Central units. Both these practices are widespread in India, particularly in the case of State sales taxes. The States compete with one another to maximize revenues and to attract industrial activity by lowering tax rates and giving tax concessions on inputs and outputs by way of tax deferment or tax holiday. In the event, many a times, considerations of efficiency and equity do not get reflected in the tax structure.

Another source of tax distortion in a federal polity arises from inter-jurisdictional tax exportation. Even when the taxes are designed on destination principle, input taxation can result in exportation of tax burden to residents of other States. In addition, in the Indian situation, the States can actually levy a tax on inter-State sale and this has led to significant levels of inter-State tax exportation.

Interestingly, the Indian tax system has been a subject matter of detailed analysis from time to time both by academic scholars and official committees. The features of the tax system highlighted above have been brought out in many studies and official reports. The attempts made to reform these inadequacies and extent of their success are examined next.

II. TAX REFORMS IN INDIA

A historical review

Since independence, there have been several attempts to reform the Indian tax system. Enhancing revenue productivity of the tax system has been the principal motivating factor for reforms. In most cases, minimization of distortions in resource allocations has not been a main objective, though official committees kept this in view in making their recommendations. Their recommendations generally reflected the economic philosophy and the development strategy adopted at the relevant time. Moreover, actual implementation of reform has fallen short of recommendations of expert committees, a major reason being that the

[5] According to the recommendations of the Ninth Finance Commission, 85 per cent of net proceeds of individual income tax and 45 per cent of gross revenue from basic Union excise duties are transferred to the State governments.

governments at the Central, State and local levels have not shown the same degree of enthusiasm in implementing the recommendations made by various committees as in appointing them.

The first major attempt for tax reform by the Taxation Enquiry Commission in 1953 was a comprehensive one. This reform was initiated shortly after independence with a view to orient tax policy to conform to the development planning strategy. Thus, the tax policy was to fulfill the objectives of enhancing the level of savings and investment, transferring resources from the private to the public sector and achieving the desired state of interregional and interpersonal redistribution.[6]

Since then a number of committees at Central, State, local levels, and study reports by expert bodies, have been undertaken to address specific problems relevant to individual taxes at Central, State and local levels. Although the scope of these attempts was partial, their recommendations even as they were selectively implemented, have immensely contributed to the evolution of the tax system in the country.

Some of committees appointed in the past to review and reform taxes levied by the Central government deserve special mention in this connection. India was the first to introduce an expenditure tax in 1957/58, based on the report prepared by Nicholas Kaldor (1956).[7] The Direct Taxes Review Committee (Wanchoo Committee, 1971), after a detailed review, recommended substantial reduction in the marginal rates of income taxes from the confiscatory levels that prevailed earlier. The method of taxing agricultural incomes on a presumptive basis was explored in the report of the Raj Committee (1972). The Jha Committee (1978) made a detailed examination of the indirect tax system in the country and one of the important recommendations made by the Committee eventually resulted in the Government adopting a manufacturing stage modified value added tax (MODVAT) at the Central level in place of the cascading manufacturing taxes. The reports of the Economic Administrative Reforms Commission on various taxes examined the issue of simplifying and rationalizing not only the structure of different taxes but also their administration and enforcement. Also a Long Term Fiscal Policy (LTFP) was formulated in the mid-1980s with a view to reversing the trend in public dissavings and to enhance the share of direct taxes in total tax revenue.

A major initiative in the tax reform exercise, however, has been taken in the early 1990s. The persistent fiscal imbalance in the 1980s had created macroeconomic and balance-of-payments problems and the economy was pushed into a crisis in 1990. Tax reforms had to be initiated as a part of the stabilization and structural adjustment programme. The Tax Reform Committee appointed in August 1991 was required to recommend measures to make the tax system "simple, credible, yet progressive". The report, in turn, said that it would, "set the trend for inaugurating a new era in the development of tax policy, structure and administration". The Committee was required to examine the entire Central tax system covering issues relating to structure, administration, enforcement and compliance of various taxes. The State taxes were kept outside the scope of the tax reform committee, but given the overlap in

[6] For the evaluation of the effectiveness in tax policy in achieving these objectives. See A. Bagchi and Pulin Nayak, "A survey of public finance and planning process: The Indian experience" in A. Bagchi and Nicholas Stern (eds), *Tax Policy and Planning in Developing Countries* (New Delhi, Oxford University Press, 1994).

[7] These are Committees named after their respective Chairmen were appointed by the Government of India from time to time to examine issue in reform of the Indian tax systems.

commodity taxes, the committee did examine some issues relating to State taxes. This was followed by an announcement of a study on the issues involved in introducing a comprehensive value added tax (VAT). Taken together, the tax reform efforts of the 1990s must be considered comprehensive.

At the State level also, a number of committees were appointed and studies sponsored at different times to examine the structure and operation of various taxes. Virtually all major States have appointed one or more of the committees to review some or all of the State/local taxes at one time or another. In general, the main objective of these exercises has been to raise more revenues. Important among the State tax committees were the Commodity Taxes Enquiry Committee Report in Kerala (1974), two tax reform committees in Uttar Pradesh (1975, 1980) and the Report of the Gujarat Taxation Enquiry Commission (1980).

The significance of the various reform attempts and their impact on evolving the Central and State tax systems are understood better by analysing the individual taxes. In what follows, an attempt is made to analyse the reforms in major direct and indirect taxes, particularly since the beginning of the 1980s.

That approaches to tax reform broadly reflected the philosophy of the time is seen in the changing perception on equity. The changed perception came to place more emphasis on horizontal equity (persons with equal ability paying equal amount of taxes) than on vertical equity (to achieve redistribution of income). In the early 1950s, the Taxation Enquiry Committee had stated that equity consideration in tax reform should not be allowed to have any undue adverse repercussion on private productive effort and enterprise. Yet, the committee had recommended a steeply progressive rate structure with the income at the highest bracket taxed at 85 per cent. The late 1950s also saw far reaching reforms in direct taxes with the introduction of an integrated tax system in which an expenditure tax, a wealth tax, a capital gains tax and a gift tax, supplemented the income tax, on the basis of the recommendations of the Kaldor Committee (1956). The expenditure tax experience, however, did not yield the desired increases in revenue; the government continued to levy the income tax at very high rates contrary to Kaldor's recommendations. The expenditure tax was suspended in 1962, reintroduced in 1964 and finally abolished in 1966.

By the early 1970s, with the levy of a 10 per cent surcharge on the income tax rate, the highest marginal rate of income tax had risen to 93.5 per cent. The wealth tax rate rose to 8 per cent. The revenue from these taxes, however, remained inelastic and this was attributed to widespread tax evasion.[8] Following the recommendations of Direct Taxes Enquiry Committee (1971), the top marginal tax rates were reduced to 77 per cent in 1974/75 and then to 66 per cent in 1976/77. Similarly, the highest wealth tax rate was reduced to 2.5 per cent. The trend was partially reversed during 1977/78 and 1979/80.

In the 1980s, there was a resurgence of interest in reforming direct taxes. The recommendation made by the reports of the Economic Administrative Reforms Commission, the Long Term Fiscal Policy Document (1985), the discussion paper on "Simplification and Rationalization of Direct Tax Laws" (1986) and the Report of the Study Group on Taxation

[8] For an analysis of elasticity of income tax see, A. Bagchi and M.G. Rao, "Elasticity of non-corporate income tax in India", *Economic and Political Weekly*, vol. XVII (4 September 1982).

of Expenditure (1977) formed the basis of the reforms. Moderation in tax rates, simplification in the tax structure and improvement in the administration and enforcement constituted the core of the tax reforms during the decade. However, while the recommendations relating to the reduction in tax rates were implemented, no significant steps were taken to strengthen administration and enforcement. In the event, the income tax got the worst of both the worlds of having a narrow base and low rates.

The process of broadening the base, moderating the rates, simplifying the tax structure and strengthening the administration, and enforcements, organization and procedures of indirect taxes were addressed more comprehensively in the interim report of the Taxation Reforms Committee (TRC, 1991), and in the first part of its final report than ever before. The motivation for these comprehensive reforms reflected the prevailing economic environment and the desire to give larger role to the market forces in economic activity. At the same time, larger resources had to be raised to reduce budget deficits and also to enable the government to reduce its dependence on import duties. To impart greater progressivity to the tax system, the trend of declining share of direct taxes had to be reversed. It was also important not to create serious disincentives towards work effort, savings and investment or for evasion and avoidance of taxes. This called for moderate and less differentiated rates and a strengthening of the administration and enforcement machinery.

The full set of reforms recently recommended were yet to take effect. The tasks involved in the implementation of reforms will be better understood from an examination of reforms in the structure of major direct taxes in India.

Direct taxes

Income tax

An important feature of the Indian income tax system is its narrow coverage. The gross income assessed for income tax in 1990/91 was just about 6 per cent of total GDP and 18.8 per cent of non-agricultural GDP (table 3). Similarly, the number of individuals paying the tax formed only about 0.6 per cent of the population.

One of the reasons for the narrow coverage of personal tax in India is the exemption of agricultural incomes from the tax net. The Constitution does not empower the Centre to levy taxes on agricultural incomes and wealth, and this alone excludes almost 30 per cent of the incomes from the tax base. There has been a lot of discussions on the desirability of extending the tax to agricultural incomes and feasible methods of taxing agricultural incomes have been explored.[9] However, income from agriculture continues to be exempted.

High exemption level and deductions for providing incentives for savings and to fulfill socioeconomic objectives is another reason for the narrow coverage. The minimum exemption limit for personal income tax was more than 6 times the average per capital income in the country in 1980/81. It remained almost five times the average per capita income as of 1987/88. This has however come down and stood at 3.5 times in 1992/93 (table 4).

[9] A. Bagchi, "Agricultural holdings tax – A modified scheme", *Economic and Political Weekly*, vol. 13, No. 8 (1978).

Table 3. Indices of the coverage of income tax

(i) Number of individuals who paid income tax in 1991/92	Rs	5.1 million
(ii) Estimated population in 1991/92	Rs	856.0 million
(i) as per cent of (ii)		0.60 per cent
(iii) Gross income assessed for income tax in 1990/91[a]	Rs	322.15 billion
(iv) GDP at market prices in 1990/91	Rs	5 320.3 billion
(v) Non-agricultural GDP at factor cost in 1990/91	Rs	1 711.7 billion
(iii) as per cent of (iv) 6.1 per cent		
(iii) as per cent of (v) 18.8 per cent		

[a] Estimated on the basis of the ratio of tax paid to gross incomes taken from all India Income Tax Statistics (AIITS).

Table 4. Exemption limit and per capita income

Financial year	*Exemption limit (Rs)*	*Per capita NNP*	*Ratio of exemption limit to per capita NNP*
1965/66	3 000	458.7	6.54
1970/71	4 000	674.7	5.93
1975/76	8 000	1 121.3	7.13
1980/81	10 000	1 630.1	6.13
1985/86	18 000	2 730.2	6.59
1986/87	18 000	2 962.4	6.08
1987/88	18 000	3 285.4	5.48
1988/89	18 000	3 842.1	4.68
1989/90	18 000	4 354.4	4.13
1990/91	18 000	4 964.2	3.63
1991/92	22 000	5 582.6	3.94
1992/93	22 000	6 249.3	3.52

Source: A. Das-Gupta and D. Mookherjee, "Reform of Indian income tax enforcement: an introduction to the issues", paper presented in the Institutional Reform and the Informal Sector Conference at Delhi, 4-5 March 1994.

In order to provide incentives for savings, tax concessions are given in two forms. Currently tax deduction is allowed, at the rate of 20 per cent of tax payable, upto a maximum of Rs 40,000 for in certain specified investment such as insurance premium, provident fund, unit linked insurance plans, superannuation funds, national savings certificates, equity linked saving schemes of mutual funds and contractual housing schemes. Although this is an improvement over the pre-1991 system of exempting such contributions altogether from the tax base, it still reduces the tax liability substantially, discriminates against different forms of savings by altering relative rates of return on various assets. Its effects on enhancing overall savings remain doubtful. Secondly, incomes from bank deposits and from specified assets upto Rs 15,000 are exempt. Exemption is also given to interest on notified bonds and debentures and interest received from the government on the money due on retirement. Finally, tax deduction is allowed also for contributions to specified social/economic development activities.

Another reason for the narrow coverage of the tax is the proliferation of in-kind incomes as perquisites. In spite of TRC recommendation (1991), no attempt has so far been made to satisfactorily tax perquisites like rent free or concessionally charged residential accommodation, free or subsidized use of motor vehicles, free or subsidized travel, or other travel, educational and medical benefits.

Capital gains in India are subject to more lenient tax treatment. The long-term capital gains of under Rs 10,000 are exempt from tax. Long-term capital gains from the sale of houses reinvested in other houses or from the sale of assets reinvested in other specified assets or house properties do not attract tax. Long-term capital losses can be set off against short-term gains and short-term losses against long-term gains. These rollover provisions further reduce the tax liability considerably. From 1991/92, the capital gains are computed after adjusting for inflation on the basis of a formula recommended by the TRC.

Extending taxation to the informal sector, particularly to the self-employed professionals and "hard-to-tax groups", presents one of the most difficult problems in all developing countries. The presumptive taxation is found to be the only practical method of extending the coverage to this class of taxpayers. The TRC made detailed recommendation on taxing such groups. The Government in the 1992/93 budget extended the facility to pay a lump sum tax of Rs 1,400 to small traders with turnover less than Rs 500,000. The presumptive taxation has been extended to transport operators and contractors in the 1994/95 budget. A major shortcoming of the measure is that the lump sum payment of the tax is optional.

As already mentioned, with the changing philosophy during the last two decades, the structure of personal income tax rates has undergone significant changes. The fear that high marginal tax rates created serious disincentives for economic activity led to reduction in the highest marginal tax rates from 93.5 per cent in the early 1970s to 66 per cent in 1976/77. The process of reducing the highest marginal rate continued during the 1980s. The most persuasive argument to having reasonable tax rates but better enforcement came from a study which argued that high marginal tax rates were the principal cause of tax evasion and the generation of a parallel informal economy.[10] By 1990/91, the marginal tax rate had declined to 54 per cent (50 per cent plus a surcharge of 8 per cent) which was further reduced to 44.8 per cent (40 per cent plus 12 per cent surcharge) in response to the recommendations of the TRC. The 1994/95 budget removed the surcharge on the tax and thus reduced the tax rate to 40 per cent.

Wealth tax

The trend in reform was broadly similar in the case of the wealth tax. The highest rate of wealth tax, which was 8 per cent in the early 1970s, was reduced to 2.5 per cent in 1976/77. The TRC made a number of recommendations to extend the coverage of the tax to forms of wealth like farm houses, urban land and buildings, residential houses, motor cars, bullion and jewellery, yachts and boats, and planes. It has also recommended that the tax should be extended to both public and private companies. These proposals relating to broadening of the tax base have not been implemented. The Government, however, (based on the TRC recommendations) increased the exemption limit to Rs 1.5 million, reduced the highest marginal tax rate to 1 per cent, and exempted the wealth held in the form of productive assets like shares, securities, bonds, bank deposits and investments in mutual funds.

[10] Archarya, op cit.

Corporation tax

With regard to corporation tax, India has had a "classical system" wherein companies are treated as independent entities. A tax is levied on the total profits of a corporation and the dividends are taxed again in the hands of the shareholders. The relative merits and demerits of the classical system and its alternatives – the imputation and the split rate systems are discussed widely in tax literature.[11] The well-known drawbacks of the classical system are: it discriminates against incorporated business *vis-à-vis* unincorporated business; dividend incomes are taxed more heavily than other incomes; retained profits are treated more favourably than dividends issued; and debt finance gets preferential treatment over equity finance. Yet, for administrative reasons, the classical system of company taxation has continued to be favoured in India as also in many other countries.

Until 1993/94, the company tax rates were different for "widely held" and "closely held" domestic companies. The distinction was removed in the 1994/95 budget and the profits of all domestic companies are now taxed at 40 per cent. The companies having income in excess of Rs 75,000 are, in addition, subject to a surcharge of 15 per cent of the tax payable. The long-term capital gains of the companies are subject to 30 per cent tax. The tax treatment of foreign companies is broadly similar to that of domestic companies, except that the former are not given exemption on export profits and limits are fixed on their head office expenses.

Indirect taxes

The major indirect taxes are (i) the import duties, (ii) union excise duties, and (iii) the sales taxes levied by the States. There are also other State and local taxes like taxes on transport (motor vehicles and passengers and goods). State excise duty on liquor and other intoxicants, electricity duty, entertainment taxes, tax on profession and property and the octroi (the tax on the entry of goods into a local area for consumption, use or sale) are all administered by the states. A detailed analysis of all these taxes cannot be undertaken here. An attempt is made to bring out the salient features of evolution of the structure of the major indirect taxes in the country.

Import duties

The evolution of import duty structure in India closely followed the logic of import-substituting industrialization adopted in the five year plans. Imports of almost all consumer goods were banned, and high and differentiated nominal rates were levied on capital and intermediate goods, resulting in large variations in the effective rate of protection. The thrust for tariff reforms came from the Report of the Alexander Committee and the LTFP document (1985). These reports emphasized the need to have lower, less differentiated and more uniform rates, and to shift, over time, from quantitative restriction to tariffs. The LTFP suggested a five-tier duty structure with essential goods and life saving drugs subject to zero rate; universal intermediates subject to lower rates than raw materials; raw materials at lower rates than the capital goods; and finally, the highest rate on consumer goods. Some rationalization had been already effected by reducing rate differentiation and replacing quantitative restriction with tariffs during the latter part of the 1980s. However, as a larger portion of proceeds from

[11] C.E. McLure, Jr., "Integration of the personal and corporate income taxes: The missing element in recent tax reform proposals", *Harvard Law Review*, vol. 88 (1975), pp. 532-582.

individual income tax and specially of union excise duties were assigned to the States after the recommendations of the Seventh Finance Commission, the Centre increasingly employed import duties as a revenue raising instrument.[12] Thus, the tariff rates showed a sharp increase rather than decline; the import-weighed average rate of nominal tariffs increased from 38 per cent in 1980/81 to 87 per cent in 1989/90.

Some rationalization was effected in July 1991 when the economic crisis forced the country to undertake the structural adjustment programme. The budget for 1991/92 reduced the peak rate of basic plus auxiliary duty to 150 per cent. The peak basic rate was reduced to 110 per cent in 1991/92, 85 per cent in 1993/94 and further to 65 per cent in 1994/95. The duty on project imports and of general capital goods imports was similarly reduced in stages to 25 per cent. The import duty on parts was made uniform and reduced to 25 per cent. There was also a considerable simplification and rationalization of the import duty structure by merging the auxiliary duties with the basic, reducing the multiplicity of rates from more than 20 in 1991/92 to 5-6 and by reducing end-use exemptions. The loss of revenue from the reduction and rationalization of import duties will have to be made good by raising larger revenues from other domestic taxes and the expected expansion in import volumes.

Union excise duties

The Indian Constitution empowers the Central government to levy excise duty on manufactured goods. The tax, initially levied on tobacco manufactures and safety matches, was gradually extended to more commodities. At the present as many as 139 commodity groups are subject to the tax. As the States also have the power to levy sales taxes, virtually two parallel systems of commodity taxation have come into existence.

The structure of excise duties has important allocative implications. First, the tax was initially levied on inputs, outputs as well as capital goods. Concerned with the cascading effects of such a tax, the Indirect Taxes Enquiry Committee (1978) suggested conversion of the tax into a Manufacturing Value Added Tax (MANVAT) by giving credit to tax paid on the inputs. The Government implemented the recommendation partially by introducing the Modified Value Added Tax (MODVAT) in 1986, though the coverage remained narrow. Initially, input tax credit was given only to a few commodities, but the facility was extended over the years. The 1994-1995 budget extended the MODVAT scheme to capital goods sector and petroleum products.

The 1994/95 budget made far-reaching changes in the structure of Union excise duties, based on the recommendations of the TRC. Switching over to taxation based on ad valorem basis in respect of a number of commodities and reduction in the number of tax rates levied on items like petroleum products, cotton and man made fabrics, fibres and yarn, metals, medicines and drugs, chemicals and paper, are the major steps in making the levy simple and transparent. A major measure at broadening the base was attempted when the three important services of telephones, non-life insurance and stock brokers were brought within the purview of taxation by levying a 5 per cent tax on these services. Another important procedural simplification was the determining of values on the basis of invoices instead of basing them on the price lists filled in advance by the assessees.

[12] The recommendation of the Seventh Finance Commission increased the States' share of Union excise duty from 20 to 40 per cent.

Sales taxes

Sales tax in India is levied by the States. It is actually the mainstay of state finances. The revenue from the tax forms about 60 per cent of States' own tax revenues and it finances over 25 per cent of States' current (revenue) expenditure. Sales tax is a broad based levy covering both manufactured goods and many primary products. The tax is, however, leviable only on goods; and services are exempt. The export of goods out of the country are excluded from the tax, but inter-State sales are taxable.

The basic framework for the levy of sales taxation was provided in the Taxation Enquiry Committee Report, 1954. The committee desired that the sales tax should be a broad based levy with minimum exemptions, should be generally levied at the last point of sale, though in selected cases low multi-point levy could complement it. Also, the committee was not in favour of the first point tax except in some limited cases. The committee recommended that except the goods exported out of the country, and subject to the ceiling rates set forth by the Central government on inter-State sale of goods and goods covered under the Essential Goods Act, 1952, the States would have the right to determine the exemptions, the structure of rates and the form of levy.

The sales tax systems in the States developed over the years have acquired some important characteristics. Each State has a list of goods to be exempted and this has been done mainly for reasons of equity, administrative convenience and social policy. The tax can be levied at the first, the last or in multiple stages. However, over the years, for administrative reasons, the States have increasingly switched over to the levy at the first point of sale. Both inputs and outputs are subject to tax, though the tax rates on the former are generally lower. There are wide differences in the tax rates on different commodities within each of the States and also for the same commodity between different States. As already mentioned, the tax is levied also on inter-State sale of goods. Some items which are considered important from the viewpoint of inter-State trade and commerce are designated as "declared goods" and the tax rate on them is subject to a ceiling.

The analysis of sales tax reforms in a comprehensive framework of improving commodity tax system in the country was made mainly in the TEC report and the Report of the Indirect Taxes Enquiry Committee (1978). The recent NIPFP study on value added tax done at the request of the Finance Minister is also an attempt at reforming the whole of the commodity tax structure. Such an integrated view has the advantage that it approaches tax reform from the viewpoint of the economy as a whole and not of any particular State, and sales tax reform is addressed in conjunction with other major Central taxes like the Union excise duties and customs.

In addition to these attempts at comprehensive reform of the commodity tax structure, there has been a number of reform initiatives undertaken by various States. Virtually every State has appointed one or more tax reform committees, or study groups have sponsored expert studies from time to time with a view to recommending measures to enhance revenue productivity. The recommendations of these expert groups have not always been unidirectional. However some common features are observed. First, the opinion of the expert bodies generally has favoured extension of the tax upto the retail stage. Mention must be made of the recommendation to that effect by the TEC, the Indirect Taxes Enquiry Committee Report,

and the State level committees in Karnataka (1982), Uttar Pradesh (1975, 1980) and Gujarat (1980).[13] Yet, in the evolution of the sales tax system in the country the move has been in the opposite direction – towards the first point levy. None of the States made any attempt to improve the administrative requirements to implement less distortionary tax; instead attempt has been to adopt the tax structure to suit what was perceived as an administrative convenience.

Second, although initially the taxation of inter-State sale was introduce as a measure to check tax evasion by monitoring inter-State movement of goods and to minimize unintended distortions due to inter-State tax differentials, over the years, this has been used more as revenue measures. Given the emphasis on revenue, there has been a considerable pressure by virtually every State to extend the tax to cover inter-State consignment transfers as well. The predominance of first point levy and taxation of inter-State trade make the tax system origin based.

Third, with the development and diversification of the markets in more recent years in different States and increased mobility of capital, tax competition has become an important consideration in determining tax rates. Tax rates have been determined with a view to attract trade or capital into the jurisdictions of a State or to prevent diversion of trade to other States.

Another important feature is the continued reliance on search and seizure operations and checkposts at the State borders (and in some cases even inside State borders) to enforce the tax. In part, this is related to the attempt by the administrators to adjust the tax structure to prevailing constraints rather than removing the constraints to enable less distorting form of levy. The information system has continued to be rudimentary and computerization to help in the assessment and in enforcing the tax has just not taken off. This has happened in spite of the expert opinion emphasizing the need to improve the computerized information system for administration and enforcement of the tax.

Octroi

The commodity tax with the most serious adverse effects on resource allocation is octroi, the tax on the entry of goods into a local area for consumption, use or sale. This is a tax levied by the urban local bodies. Like in the case of customs and excises at the Centre and sales tax at the State level, octroi is the principal source of revenue for the urban local bodies in many States. This is both a lucrative and a liquid source of revenue to the cash starved municipal bodies. This checkpost based levy is collected at the entry points into local body jurisdictions. The tax is assessed by the personnel manning the checkposts. They have the discretion to determine the tax liability and this results in widespread corruption. The additional protection offered by this tax tends to encourage the inflow of trade and industry inside urban jurisdictions – particularly in the centres of entreport trade such as Bombay, resulting in overcrowding and congestion in urban areas. What is more, the tax has led to the creation of serious impediments to the free movement of goods across different regions. The tax is also found to be regressive. Furthermore, some of the important metropolitan centres have found this to be an easy way of exporting the tax burden to non-residents. There is unanimity among the fiscal experts on the desirability of abolishing the tax; all committees,

[13] The notable exception to this is the Gulati Committee Report in Kerala (1976), which actually made out a case for switching over to the first point levy on administrative grounds.

commissions and study groups unequivocally have recommended its abolition. Yet, the tax continues to be levied in many municipal areas for want of a viable alternative.

Reform in tax administration

An inherent part of tax system reforms is improvement in administration and enforcement. In a developing country like India, a large proportion of economic activity is in the informal sector, and self-employed, hard-to-tax groups and those who are politically influential find ways and means to evade and avoid taxes. Improvement in administration and enforcement in such a situation is important not only to enhance the productivity of the tax system but also to ensure justice in taxation in terms of equal treatment of equals. This calls for a simple tax structure, reasonable tax rates, proper information system, stringent penal provisions and effective and speedy disposal of assessment and appeals. In this regard the performance of the tax system in India leaves much to be desired.

Tax administration is an under researched area. Available studies clearly bring out the sharp decline in the quantity and quality in scrutinizing assessments.[14] The effect of tax raid, search and prosecution on taxpayer compliance was found to be insignificant. The frequent amnesties granted by the government also was not favourable for tax compliance. The studies brought out the deficiencies in tax administration, including manpower allocation, target-setting and performance evaluation of officers, prosecution policy, and the information system.

The complexity of the tax system and associated legislations is one of the major difficulty for tax administration in India. In spite of the attempted reforms, the structure of both direct and indirect taxes has continued to be complex with large exemptions, high tax rates and multiple rates resulting in misclassification, classificatory disputes and numerous loopholes. Administering a complex tax structure calls for complex legislation. In the event, the tax departments simply get caught up in the "vicious circle" of complex legislation causing more disputes and more loopholes, and attempts to overcome these through even more complex legislation.

Another factor causing administrative problems is the fear of audit objections against any revenue losses on account of administrative lapses. This results in the tax officials taking the line of least resistance and invariably making assessments in favour of the government. This not only brings in arbitrariness but also leads to large scale litigation and eventually results in the officials remaining busy preparing court cases leaving very little time for assessment and planning work. The arbitrariness results in inequity and the time of tax officials is wasted in meeting frivolous audit objections and litigation which, in turn, adds to arrears.

Poor information system results in making assessments merely on the basis of the information supplied in the tax return. Detecting evasion in such cases has to depend mainly on search and seizure operations. This leads to harassment of taxpayers and does not increase the probability of detecting tax evasion appreciably, as only a limited number of such operations can be done in any year. Scientific information system and computerization not only helps

[14] A. Das-Gupta, D. Mookherjee and Panta, "Income tax enforcement in India: A preliminary analysis" (New Delhi, National Institute of Public Finance and Policy, 1992); and A. Das-Gupta, R. Lahiri and D. Mookherjee, "An econometric analysis of income tax compliance in India", 1972-89 NIPFP Current Policy Issues Paper No. 22 (1992).

in making proper assessment of the tax but also in detecting tax evasion cases, and enhances voluntary compliance.

The TRC (1993) went into the problem of tax administration in detail and identified a number of factors contributing to the unsatisfactory state of affairs. Important among these are (i) high tax rates, (ii) multiplicity of rates leading to classification of dutiable goods into numerous rate categories, (iii) frequent and recurrent changes in the law brought in during the budget time conceived in secrecy and enacted without adequate public discussion, (iv) variety of exemptions, concessions and deductions introduced in tax laws to fulfill a number of non-revenue objectives, (v) changes in the exemptions and rate structures throughout the year by issuing notifications, (vi) the practice of fixing revenue collection targets – often unrealistically, (vii) the tendency to overassess for fear of audit objection and pursuing cases even when the tax department is convinced that the case does not exist, and the resulting increased litigation and inefficient utilization of the time of the assessing officers, (viii) lack of accountability – habitual overassessment and collection of illegal gratification, not inviting commensurate punishment, (ix) relentless pursuit of short-term revenue gains, often for fear of audit, resulting in considerable infructuous work and prolonged litigation, (x) concentration of work on returns filed and tax deducted at source which leaves little time to gather information on potential taxpayers who escape the tax net, (xi) laxity in administration, political interference resulting in low morale of honest and efficient officers, and (xii) lack of adequate training, promotion on the basis of seniority rather than work performance and honesty.

To remedy the above, the Committee made the following recommendations: (i) switching over to the regime of reasonable tax rates, (ii) doing away with the practice of issuing notification throughout the year to accommodate various lobbies, (iii) keeping the tax laws simple and stable, (iv) avoiding unrealistic target fixing to minimize overassessments and unjustified penalties, (iv) fixing accountability for the officers for the mistakes of either over or underassessment, (iv) providing better training of the officers to educate them on the scope of their work: in computerization of work, on the economic consequences of taxation, on changing international practices, and for improving the morale of the officers through training as well as promotions based on performance appraisal, (vi) setting up efficient and responsive grievance redressal machinery and (vii) aiming at adequate taxpayer education and publicity.

The TRC has also identified specific problems with regard to the administration of direct and indirect taxes and recommended specific measures to overcome them. The committee has made a number of recommendations for "modernizing the administrative system in order to achieve better taxpayer control, correcting structural failures that result in overlap of functions, lack of continuity and effectiveness of the processes; and promoting deconcentration". The Committee made comprehensive recommendations to achieve effective taxpayer identification and control, file containing all relevant data on the taxpayers, a proper verification system and efficient summary assessment, development of a taxpayer information system, reforms in search and seizures, and the creation of a direct tax code. For reasons of space, the details are left out here.

In the case of excise taxes, assessment and collection procedures are outmode the tax being collected on the basis of clearance of every separate consignment of goods out of the factory simply on the strength of pre-authenticated gate passes. In short, the TRC identified

the following problems areas: (i) complicated code of rates and procedures, (ii) outdated procedures not keeping pace with changes in the administrative structure, (iii) unsatisfactory inspection system, (iv) outmoded system of reporting and monitoring, (v) inadequate training of officers particularly in specialized functions and their improper placement, (vi) frequent changes in the rules and procedures, and (vii) inordinate delays in the disposal of appeals by the Tribunals and inability of the manual system to cope with the number of documents and hence the need for computerization.

The committee also made a number of recommendations. These include measures to update and simplify procedures, improve the system of inspection and monitoring, improve training facilities both within the department and outside to keep up with the latest internationally followed procedures and practices, publication of draft notification regarding changes in procedures, proper classification and valuation of excisable and imported goods, and improved testing facilities, and simplification of procedures. In the 1994/95 budget, a few of these recommendations have been implemented including switch over to assessments on the basis of invoices.

The problem is more or less similar in the case of sales taxes. The high and multiplicity of rates, wide ranging exemptions including end-use exemptions, complicated forms and practices, outmoded method of assessment, reliance on search, seizures and checkposts for the enforcement of taxes, virtual absence of an information system and absence of computerization for assessment and cross-checking of returns, are the major shortcomings in the administration of sales taxes. As the sales tax is a broad-based tax, even the retailers above the prescribed turnover limit are required to register with the departments. The personal contact of the tax officials with a large number of traders naturally results in their collusion resulting in corruption and low morale of honest officials.

The appellate system too is found to have a number of problems. A large number of pendencies in the tribunals in the case of Customs and Central excises and at all appellate levels in the case of direct taxes is found to be a major problem. This has arisen on account of repetitive appeals, under-staffed benches, seeking frequent adjournments both by the departments and the assessees, lack of coordination between chiefs of departments and the collectors of customs and excise or commissioners of income tax, and absence of a mechanism to prevent filing of petty appeals. These have resulted in increasing pendency. Absence of a clear-cut guidance to guard against frivolous appeals, lack of satisfactory facilities to appellate authorities and members of tribunals, inadequate infrastructural support and inadequate expertise of departmental representatives who are often pitted against the best lawyers, selection of unsuitable personnel for various jobs and absence of requisite training facilities are the other shortcomings. The TRC has also recommended a number of measures to reduce the generation of appeals, improve the quality of departmental representatives in fighting departmental cases, improvement in work facilities, augmenting the strength of the members of tribunals and other appellate authorities, reorganization of tribunals and removal of administrative control of the departments over the tribunals, and reducing appeals from public sector undertakings through the requirement of inter-Ministerial clearances.

The above discussion on administration and enforcement of taxes clearly brings out one important fact. By simplifying the structure of taxes, improving the information system, properly reorganizing the administrative set up to make it more responsible and responsive,

and by ensuring accountability as well as offering incentives to the officials, it is possible to make significant increases in revenue and should be a priority area for future reform.

III. TAXATION, REDISTRIBUTION AND ECONOMIC GROWTH

Tax policy and poverty alleviation

The principal objective of development planning in India has been to hasten the process of economic growth and to bring about rapid improvement in the living conditions of the poor. The instrument of fiscal policy was assigned the responsibility of enhancing the levels of saving and investment, transferring the savings to desired investment activities and bringing about the desired state of inter-personal redistribution. Tax policy, being a major component of fiscal policy, therefore, had to play an important role in the task of achieving economic growth with equity.

The experience of tax policies in various countries has shown that the efficacy of these policies in directly redistributing incomes and thus improving their well-being is limited. The attempts at reducing the incomes of the rich through tax policy does not amount to increasing the incomes of the poor. Such pure redistribution may, on the one hand, reduce the overall income level in the economy by adversely affecting the incentives and, on the other, may not necessarily enhance the incomes of the poor in a sustained manner. The more important role of tax policy in poverty alleviation is indirect – it should raise the revenues required to undertake short-term and long-term measures to combat poverty. In other words, the tax system should generate sufficient revenues for financing the creation of social and economic infrastructure necessary to enable proper utilization of resources which can reduce unemployment and poverty; and also for direct spending on self-employment and wage employment schemes and doles to those who are unemployable.

The efficacy of fiscal policy in achieving these is greater, if the required revenues are raised with minimum resource distortions and from relatively higher income groups. Redistribution is possible only when government expenditures have a progressive bias in terms of higher benefits going to the relatively poor persons through higher empowerment. Similarly, the amount required to impart a progressive expenditure bias would be higher if the revenues are raised in a regressive manner. An attempt is made to examine the redistributive effects of tax and expenditure policy in the light of the available evidence and also examine the allocative consequences of tax policy to identify its distortionary effects.

Progressivity in the tax structure

The general approach to tax incidence studies in most developing countries has been to allocate the tax burden among the persons/households belonging to various income/consumption groups on the basis of "shifting" assumptions made in the context of developed countries, which may not apply in a typical developing economy case. In the Indian context, the weaknesses of the incidence studies are even more glaring. Most of the studies estimate tax incidence, following a partial equilibrium framework.

Yet, the examination of the tax structure and the results of the incidence studies help to arrive at the following broad inferences. First, both direct and indirect taxes are found to progressively distribute the tax burden. Second, the increasing share of indirect taxes (including trade taxes) and administered prices on public monopolies in total revenue indicated a declining progressivity of the tax structure as a whole. Third, during the 1980s the government's reliance on fiscal deficit to finance expenditures has been much larger than in the previous decades and a greater proportion of the fiscal deficit was monetized in the 1980s (table 5). As it is well recognized inflation is a form of regressive tax and increasing resort to inflationary finance over the years has reduced the overall progressivity of the fiscal system.

Empirical studies using All India Income Tax Statistics (AIITS) show a progressive distribution of tax burden. The degree of concentration of post-tax incomes are found to be appreciably lower than that of pre-tax incomes.[15] These data however relate only to declared incomes and only those returns that are actually tabulated in AIITS. Clearly the coverage of income tax is narrow and undeclared incomes are significant. It is doubtful whether the inclusion of these in the calculation would still show overall progressivity in the distribution of tax burden.

The first notable study on the incidence of indirect taxation was carried out in 1953/54 by the Taxation Enquiry Commission (1954). In this study, percentage of tax paid in consumer expenditure was taken as a measure of tax incidence. Such exercises were repli-

Table 5. Trends in revenue/fiscal/budgetary deficits of centre and states (combined): 1970/71 to 1990/91 (As percentage of GDP at market prices)

Year	*Revenue surplus (–) Deficit (+)*	*Fiscal deficit*	*Budget deficit*
1970/71	(–) 0.34	4.59	0.89
1975/76	(–) 2.34	4.59	0.46
1979/80	(–) 0.75	6.47	2.32
Average 1970-1980	(–) 1.09	5.17	1.07
1980/81	(–) 0.09	8.09	2.54
1985/86	1.92	9.33	1.31
1989/90	3.40	9.48	2.34
Average 1980-1990	2.13	9.11	1.86
1990/91	4.46	10.04	2.16
Average 1970-1991	1.83	8.48	1.75

Source: Indian Economic Statistics/Indian Public Finance Statistics, Ministry of Finance, various issues.

Note: Minus sign denotes surplus.

[15] A. Gupta, *Study of Personal Income Taxation in India* (Calcutta, Progressive Publishers, 1975); and A. Gupta and P.K. Aggarwal, "Impact of personal income tax" (New Delhi, NIPFP, 1982).

cated in 1961 and again in 1969. The studies generally found that the indirect taxes as whole were moderately progressive.[16]

Major thrust in alleviating poverty, as mentioned earlier, has to come about not by the progressivity of tax system *per se*, but through a proper spending policy. Poverty alleviation may require a mix of long term measures to enhance growth, particularly in the sectors in which the benefits have a large trickle down component. Empowering the poor through investments in human capital and in providing wage employment, self-employment and other social security measures are among the long-term measures. Particular mention must be made of the importance of spending on agriculture and irrigation, which have played a critical role in reducing poverty in States like Punjab and Haryana.[17]

Government spending on education in India as a proportion of GDP at 3.6 per cent in 1990/91 was less than the 4.1 per cent average for all developing countries. Expenditure on elementary education that benefits the poor more was just about 40 per cent of this total. The detailed analysis of the composition of government expenditures in India shows that in 1987/88 (at 1981/82 prices), the direct expenditures on poverty alleviation in per capita terms amounted to Rs 75 (or less than 10 per cent of total) as compared to Rs 111 on defence and Rs 90 on general administration.[18]

Taxation, resource allocation and economic growth

The long-term strategy to achieve sustained reduction in poverty levels lie in enhancing economic growth in the country. Tax policy can be employed to affect the growth performance of the economy in two specific ways. First, taxation is the most important non-inflationary source of financing social and economic infrastructure. The tax system must be both growth inducing and growth responsive. Growth responsiveness of the tax system ensures revenue productivity and growth inducing implies that revenues should be raised in the least distorting manner by minimizing disincentive and distortionary effects. Second, tax instruments are also used to enhance the levels of saving and investment, though the efficiency of tax instruments in achieving this objective has been subject to question. The effects of tax policy on efficiency of resource allocation are of greater consequences.

While the efficacy of tax deductions in enhancing the levels of savings has been subject to serious doubt,[19] tax concession on different financial assets have however caused substantial variations in after tax rates of return on different financial assets which may be entirely unintended. Similarly, the concession for investments through development rebates, investment

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[16] E. Ahmed and N. Stern, "Indirect taxes and prices in India: The calculation of effective tax rates using input-output methods", Discussion Paper (Department of Economics, University of Warwick, 1982).

[17] See C.H.H. Rao, S. Ray and K. Subbarao, *Unstable Agriculture and Droughts* (New Delhi, Vikas Publishing House, 1988) for a detailed analysis of the inverse relationship between availability of irrigation and incidence of poverty.

[18] S. Mundle and M.G. Rao, "Issues in fiscal policy" in Bimal Jalan (ed), *The Indian Economy: Problems and Prospects* (1992).

[19] M.K. Rakshit, "On the inflationary impact of budget deficit", *Economic and Political Weekly*, Annual Number (1987).

allowances, capital subsidies and tax holidays in the corporation income tax, and deferment in sales taxes, have altered the rates of return on investments in various sectors and regions. It is not clear whether these allocative consequences are on intended lines. After a due consideration of the costs and benefits, the investment allowance was replaced with an IDBI deposits scheme and finally abolished altogether in 1990/91. Liberal sales tax subsidy schemes, however, persist in all the States and they continue to cause distortions in resource allocations. Although it is doubtful whether the fiscal concessions have had a beneficial effect on industrialization in the country, the States continue to compete with on another in extending liberal concessions, with tremendous loss of revenue to the exchequer.

The major problems of Indian indirect taxes, as discussed before are: vertical tax overlap, complicated structure, their cascading effects, inter-state tax exportation and competition and poor enforcement in an environment of poor information availability and processing capacity.

The complexity in the tax system, its possible effects on relative prices and allocative distortions in the economy are found to be significant in many studies. In spite of the tax reforms undertaken so far, the problem has persisted. Indeed, a comprehensive value added tax system integrating the commodity taxes levied at both Central and State levels would provide solutions to many of the existing problems.[20] The consumption type destination based value added taxes levied at the retail level at two or three rates would reduce cascading, minimize distortions in relative prices, enhance voluntary tax compliance, and increase revenue productivity. It is also important to strengthen the computerized information system to help in tax administration and enforcement. However, in a federal polity, with the prevailing tax assignments in the Constitution, it would be difficult to persuade the States to agree to such a centralized solution. Perhaps, a more acceptable solution would be to have parallel system of value added taxes at the two levels within the prevailing Constitutional constraints. Surely, switching over to a value added tax system in the Indian federal polity is the most challenging task for future of tax reforms.

IV. CONCLUDING REMARKS

An attempt has been made in this study to evaluate the efficacy of the Indian tax system, *inter alia*, in ensuring equity and alleviation of poverty. The evaluation of the "equity" objective has not been done in the conventional sense of redistributing the existing incomes among different income/consumption groups. We have examined the efficacy of tax policy from the viewpoint of bringing about sustained increases in the living conditions of the poor through effects on both economic growth and redistribution.

It has been argued in the paper that the role of tax policy in bringing about direct redistribution of incomes is limited, and attempts at serious vertical redistribution through tax policy could be counter-productive. Vigorous pursuit of vertical equity through confiscatory tax rates may not only affect incentives adversely, but also lead to widespread avoidance and evasion of taxes, thereby violating the principle of equal treatment of equals. It is argued that

[20] The study team headed by Amaresh Bagchi, NIPFP has explored alternative schemes of levying value added tax in the country. The report, however, as yet, is not available in public domain.

the role of tax policy in alleviating poverty is mainly to generate adequate revenues so that the government is enabled to undertake short-term and long-term measures to combat poverty through government expenditure policy. Such a tax policy should (i) have high revenue productivity, (ii) have minimum disincentive effects on work effort, and (iii) emphasize "equal treatment of equals". At the same time, tax policy would have greater efficacy in alleviating poverty if the required revenues are collected in a non-regressive manner.

The tax system to fulfill the above conditions should have a broad base, low and less differentiated simple rate structure, an unambiguously simple legal framework, a proper information system, and a strong and effective enforcement machinery. This implies that the growth inducing and growth responsive tax policy calls for a systemic approach to tax reform involving the tax structure, tax administration and tax compliance factors.

In these respects, the Indian tax system does not score very high points. Traditionally, tax policy in India was geared to reduce the incomes of the rich rather than increase the incomes of the poor. Accordingly, income tax was levied at confiscatory rates in the 1960s and the 1970s; this created severe disincentives and caused widespread evasion and avoidance of taxes. Pursuit of several objectives through tax policy complicated the tax structure. In addition, the operation of special interest groups rendered the tax base narrow and tax laws complex. All the factors contributed to low revenue productivity in the tax system, high disincentives, and consequently, horizontal equity was seriously violated.

A number of attempts at redesigning the tax system was made, particularly since the beginning of the 1980s. There was generally an attempt to have moderate rates. However, as there were no commensurate effort at broadening the base, strengthening tax administration and enforcement, and improving the information system, in the event, the system was left with the worst of both the worlds. The revenue productivity of the tax system stagnated, a widespread feeling of unequal treatment of equals prevailed, and the complications in the tax system distorted relative prices and added to production costs. The declining administration and enforcement standards, inefficient appellate machinery and the virtual non-existence of a scientific information system, are factors which gave rise to the feeling of inequity, and discouraged voluntary tax compliance.

Improving the revenue productivity of the tax system, imparting equity and reducing distortions are important not merely to bring about macroeconomic stabilization, but also to eliminate micro-level inefficiencies and achieve competitiveness in the Indian economy. In the 1990s, therefore, tax system reform will continue to be a priority area. The TRC has identified the problem areas and has made far reaching recommendations to reorient the tax system to conform to the market oriented, outward looking development strategy. Implementing these reforms presents a truly challenging task.

The most important and demanding is the reform of the consumption tax system in the country. Experiences in other countries have shown that the introduction of the value added tax is the single most important measure which has appreciably enhanced revenue productivity. In India, the prevailing commodity tax system needs to be reformed to minimize distortions arising from vertical tax overlapping, cascading and cost escalation, alteration in relative prices, inter-State tax competition and tax exportation. Such a reform, however, has to be undertaken

in the context of a democratic Federal polity. Given the overlapping tax powers of different jurisdictions, the issue of tax harmonization between the Centre and the States and among the States *inter se,* presents the most formidable challenge in the 1990s.

Another important area which needs greater emphasis is the reform of tax administration and the enforcement machinery, and improving the information system. The enhancement in yield has to come about mainly through improvement in voluntary tax compliance and not by raising the tax rates. To achieve this, it is necessary that the tax system should be reasonable and simple, and enforcement effective and information system comprehensive to enhance the probability of detecting evasion appreciably, coupled with high penalty rates as a deterrent to tax evasion. Reforming tax administration, the enforcement and appellate machinery, and improvement in the computerized information system to assist in tax assessment, and extending the tax net to the self-employed and hard to tax groups are also priority areas of reform in the 1990s.

INDONESIA

I. SALIENT FEATURES OF THE TAX SYSTEM

Structure of revenue

The tax system of Indonesia shares the general characteristics of the tax system of other developing economies: inflexibility, inefficiency, less progressivity, and inability to raise sufficient revenue to finance planned government expenditures. The major taxes are all assigned to the central government which also owns major state-owned enterprises as a source of non-tax revenue. Personal and corporate (including oil and gas) income taxes, major taxes on domestic transactions (sales tax, VAT and excises), taxes on international trade (export and import taxes), wealth and property taxes, and major user charges are all centrally administered. Major royalties on exploitation of natural resources, including oil and gas, mines and forests, are also collected by the central government. Proceeds from some of the taxes, such as those from the property and wealth tax, are shared (since 1994/95 fully passed on) to lower level governments based on their geographical origin. Some of the royalties on the exploitation of national resources are similarly shared.

The availability of increased revenue from oil and LNG during 1973-1982 had relieved the pressure for raising tax revenue from other sources. Revenue from oil and LNG is classified as corporate income tax in the government budget, though from the economic point of view, "Corporate Tax on Foreign Oil Companies" is similar to royalty on exploitation of oil and gas resources or an export tax. The main non-oil taxes are on foreign trade transactions (exports and imports), and on domestic consumption (sales tax, excise, VAT).

The changes in the structure of government revenue since 1969 are indicated in table 1. During the first three *Pelitas* (1969/70-1983/84), almost all of the government revenue (upto 98 per cent) was generated from taxes. During the "oil boom" period, 1973-1982, 60 to 70 per cent of all tax revenue, and most of the proceeds of the profits tax had been generated from the oil and gas sector.

Table 1 shows that tax revenue as a percentage of GDP rose from 10.2 per cent in fiscal year 1969/70 to 19.8 per cent in FY 1974/75. The highest annual average ratio of over 22 per cent was achieved during FY 1979/80 to 1982/83. Such enhancement of revenue was made possible by the positive external shocks, particularly the "oil boom" between 1973-1982, as it made it easier for the Government to raise revenue from the high priced oil. The ratio of oil revenue to GDP was only 2 per cent in 1969/70; it jumped to around 11 per cent in 1974/75 and to above 16 per cent after the second "oil boom" in 1979. The share of oil tax in total domestic receipts similarly increased from 32.7 per cent at in 1971 to 72.6 per cent in 1980, and was 65.6 per cent in 1985. Since then the share of oil revenue has gone on declining and that from non-oil taxes has been rising. The share of non-oil revenues diminished significantly during the period 1971-1984, after which it started rising and reached 64 per cent in 1993. The negative external shocks, associated above all with the decline in the price of oil, tended to reduce the ratio of government revenue to GDP since 1983/84. This however has been successfully arrested with the 1983-1985 tax reform.

Table 1. Central Government of Indonesia, aggregate indicators of revenue, FY 1969 to FY 1993

Fiscal year	Total revenue[a] (Percentage of GDP)	Tax revenue (Percentage of GDP)	Non-oil tax revenue (NOTR) (Percentage of total revenue)	Non-oil tax revenue (NOTR) (Percentage of GDP)
1969	10.2	10.2 (98.8)	79.1	8.2
1970	12.3	11.5 (93.5)	74.0	9.1
1971	13.6	12.8 (93.7)	67.3	9.2
1972	15.3	14.4 (94.1)	60.4	9.3
1973	16.9	16.0 (94.8)	59.2	10.0
1974	19.4	18.6 (96.2)	40.7	7.9
1975	20.9	19.8 (95.0)	39.2	8.2
1976	21.7	20.8 (95.9)	40.2	8.7
1977	18.6	17.8 (96.0)	40.9	7.5
1978	19.0	18.1 (95.5)	41.4	7.8
1979	22.8	21.3 (93.4)	32.3	7.4
1980	23.5	22.8 (96.9)	28.3	6.6
1981	23.3	22.8 (98.0)	27.4	6.2
1982	21.5	20.8 (96.5)	30.7	6.6
1983	19.5	18.8 (96.4)	30.4	5.9
1984	18.5	17.7 (95.7)	30.1	5.6
1985	21.4	19.7 (92.3)	34.4	7.3
1986	16.8	15.6 (92.9)	53.6	9.0
1987	18.2	16.4 (90.5)	42.2	7.7
1988	16.2	15.1 (93.2)	51.8	8.4
1989	17.2	16.0 (92.8)	53.7	9.2
1990	16.0	15.0 (93.3)	59.2	9.5
1991	17.8	16.5 (93.0)	55.6	9.9
1992	18.1	17.0 (93.7)	63.8	11.6
1993[b]	18.3	17.1 (93.2)	64.5	11.8

Sources: Calculated from Central Bureau of Statistics, *Economic Indicators*, various issues; and Bank Indonesia, *Financial Statistics*, various issues.

Note: Figures in parenthesis indicate the percentage share of tax revenue in total revenue.

[a] Consists of tax and non-tax revenue. Development revenue is excluded.
[b] Budget.

A combination of government efforts and a decline in the oil revenues raised the ratio of tax revenue from non-oil sources to GDP from 5.6 per cent in FY 1984 to 9.5 per cent in FY 1989 and to over 11 per cent since 1992. For non-oil taxes, revenue from taxes on domestic transactions and international trade have become more predominant than taxes on income and profits. Overtime, due to changing structure of the economy and of imports, the role of domestic taxes on consumption is increasing while the role of taxes on international trade is diminishing. The share of non-oil income (corporate and individual) taxes as a percentage of the proceeds of income and profit taxes however increased from 8 per cent in FY 1983 to 30 per cent in FY 1993 (table 1).

The share of government revenue from taxes on domestic transactions has increased significantly from 11.5 per cent in FY 1983 to 29-30 per cent since FY 1990. As a percentage of GDP, taxes on domestic transactions has increased from 2 per cent in FY 1983 to nearly

Table 2. Central Government of Indonesia. Revenue by broad categories, FY 1969 to FY 1993 (Percentage)

Fiscal year beginning	*Taxes on income and profits*[a]	*Taxes on domestic goods and services*[b]	*Taxes on international trade*[c]	*Others*[d]
1969	31.5 (27.35)	25.7	27.0	15.8
1970	30.8 (29.86)	23.9	29.0	16.3
1971	38.4 (35.13)	21.4	24.2	16.0
1972	45.7 (41.46)	19.6	19.1	15.6
1973	46.0 (41.64)	18.2	21.5	14.3
1974	65.6 (56.74)	13.5	13.7	7.2
1975	67.5 (58.55)	13.5	11.1	7.9
1976	65.7 (58.67)	14.2	11.4	8.7
1977	65.5 (57.45)	14.7	10.8	9.0
1978	65.2 (56.66)	14.7	11.3	8.8
1979	72.3 (65.44)	10.1	10.8	6.8
1980	77.0 (70.47)	9.1	7.6	6.3
1981	79.1 (72.65)	9.2	5.6	6.1
1982	76.2 (68.18)	11.1	5.0	7.7
1983	76.7 (68.42)	11.5	4.8	7.0
1984	82.5 (68.54)	11.5	4.1	1.9[e]
1985	75.8 (62.75)	18.4	3.7	2.1
1986	57.4 (42.27)	26.4	6.9	9.3[f]
1987	67.5 (53.37)	25.1	6.0	1.5
1988	62.9 (44.45)	27.5	6.3	3.3
1989	62.7 (42.18)	27.4	6.6	3.2
1990	58.7 (40.10)	29.6	7.1	2.9
1991	61.7 (40.26)	27.9	7.2	3.2
1992	57.1 (35.16)	30.9	7.1	4.9
1993	60.9 (30.76)	28.8	6.4	3.9

Sources: Calculated from Central Bureau of Statistics, *Economic Indicators*, various issues; Bank Indonesia, *Financial Statistics*, various issues; and Ministry of Finance, *Financial Notes*, various issues.

Note: Figures in parenthesis indicate share of oil tax in income and profits tax revenue.

[a] This category consists of personal income tax, corporate income tax, and tax on oil companies.

[b] This category consists of sales taxes and excise duties.

[c] This category consists of import and export duties.

[d] This category consists of property tax (IPEDA), stamp duties, exit taxes, and until 1983/84 withholding taxes which cannot be allocated.

[e] Beginning with 1983/84, withholding taxes have been merged with taxes on income and profits.

[f] High value is due to special oil receipts which were collected only in 1986/87.

5 per cent in 1993. The shares of taxes on international trade, measured both in terms of its share in total revenue as well as a percentage of GDP, have been diminishing, mainly reflecting the decline in nominal tariffs as well as changing structure of Indonesia's imports. Revenue from import duties and sales taxes on import are declining as more of imports consisted of capital and intermediaries goods with zero or low import tariff rates and levies. Export taxes also played a very minor role as a source of revenue, particularly following the ban on export of logs in the 1970s and raw and semi-processed rattans in the 1980s.

However, the share of excises has also been declining from 13.1 per cent of total domestic revenue in FY 1969 to 6.4 per cent in FY 1974 and remained between 6 and 5 per cent since in FY 1978. Excises have been mainly levied on tobacco related products, alcohol, and sugar.

The pre-1983 tax system thus consisted taxes mainly of the corporate and individual income tax, the sales and excise taxes and customs duties as major sources of government revenue. Some of their features and deficiency are noted below.

Weak features of major taxes

Income taxes

Prior to the reform, the base and rate of the corporate income tax in Indonesia were quite complicated. The non-oil sector was subject to tax under the Corporation Tax Ordinance of 1925, which was modified and amended several times, the latest modification being introduced by Law Nr. 8 of 1970. Tax was payable annually on net income received in the previous year by Indonesian companies, cooperatives, and partnerships. Foreign companies were liable to tax on income obtained from property or enterprises located in Indonesia. Capital gains on the sale or exchange of assets by corporations were also taxed at the normal rate.

Taxable income was defined as gross income less costs to earn the income. The latter included depreciation, pension funds and contribution to losses. Profits of state-owned enterprises operating under the Indonesian Business Act and most of the public utility enterprises were exempt from taxes. Tax holidays of up to six years were given to new investment in priority areas and locations. An investment allowance of 20 per cent was made available to companies which were not granted tax holiday privileges.

The tax rates were discriminated by company legal status, ownership, source of profit, economic sector, area of operation and, in the case of cooperatives, the age of the business establishment. A special rate was applied to companies using the service of registered public accountants. In general, the tax rates were divided into a general rate and a special rate. The general rates were 20, 30 and 45 per cent, respectively, for Rp 25 million, Rp 50 million and over Rp 50 million of taxable incomes. Foreign owned companies and joint venture enterprises, outside insurance and oil businesses, were taxed at 20 per cent on income up to Rp 10 million and 25 per cent on income above Rp 10 million. For the special rates, companies were divided into several categories, such as companies using the service of public accountants, state-owned enterprises, and the cooperatives. The special rates were ranging from 5 per cent to 45 per cent of taxable income. Net surplus of a cooperative (after deduction of payments to its members) were taxed according to the following schedules, according to the size of the surplus and the years of operations.

Taxable surplus as percentage of capital	*During the first five years following establishment*	*After the first five years*
Up to 5 per cent	0	5
5 to 10 per cent	5	10
Over 10 per cent	10	20

Special tax rates also applied for shipping and airlines companies, foreign insurance companies permanently established in Indonesia and foreign oil companies operating in the country. Shipping and airlines companies were subject to a 5 per cent tax rate on gross turnover and to normal rates for the remaining taxable profits. Life insurance companies were subject to 5 per cent tax rate and non-life to 10 per cent. Foreign based oil drilling companies were subject to 10 per cent income tax rate until 1975, and to 12 per cent subsequently.

Capital gains were also subject to special rates and discriminated according to the economic sector. A rate of 10 per cent was applied for merger of banks and insurance companies and a maximum rate of 20 per cent was applied for merger of non-financial companies. Profits from revaluation of fixed assets, the nominal increase in shares and issuance of bonus shares in certain sectors designated by the Minister of Finance, were taxed at the rate of 10 per cent.

The oil companies were subject to special individual arrangements, according to ownership, location and the size of production and marketing destinations. Pertamina, the state-oil company, required to surrender 60 per cent of its net operating income to the public treasury. Net operating income was defined as gross income less operating costs. Because of this, Pertamina was not subject to corporate income tax. Foreign based oil companies in Indonesia were classified into two groups, namely, companies under work contracts and under production sharing. Companies signing contracts prior to 1966 fell under the first category and production sharing arrangement applied subsequently. Stanvac, under the first group of oil companies, was subject to the following arrangement: 60 per cent tax rate for the net operating income up to the base price; 85 per cent rate for the net operating income in excess of the base price. On top of these, Stanvac was also liable to pay additional US$ 1 per barrel of crude oil produced by it.

PT Caltex, the major producer of oil in Indonesia, worked under production sharing arrangement but was subject to different tax arrangement similar to that applied to Stanvac. Thus a 60 per cent tax rate was applied to the net operating income up to the base price and 85 per cent rate for the net operating income in excess of the base price up to a limit production of 150 thousand barrel of oil per day. For production over 150 thousand but below 250 thousand barrel of oil per day, the tax rate was 90 per cent of net operating income and for production over 250 thousand barrel of oil per day the tax rate was 95 per cent. On top of these, PT Caltex was liable to pay an additional US$ 1 per barrel of production of crude oil. Tax credit was however given for crude exported to distant markets.

The system has been changed so that all oil companies are now operate under production sharing contracts. Under this arrangement, oil companies are subject to 85 per cent tax rate on net operating income, of which Pertamina retains 7.7 per cent as administration costs for negotiating and supervising the contracts for the Government.

Individual income tax was regulated by the 1944 Income Tax Ordinance, revised and amended by Law Nr. 9 of 1970. There were considerable confusions and contradictions in the legal provisions. Definitions of the key terms, such as income, resident, non-resident, etc, were not clearly stated. The lack of precise definitions had created uncertainty, loopholes and partial enforcement resulting in large magnitudes of tax evasion.

All incomes derived from business, employment, pensions, annuities, property and capital were subjected to the individual income tax. Non-residents were liable to tax on income generated from property, profession, business and employment in Indonesia. An alien resident, who had lived in Indonesia for 12 months or longer, was taxed on his or her total world-wide income.

In general, taxable income was defined as the difference between gross income and exemptions and deductions. For certain types of businesses, particularly in non-formal sector, such as partnership and self-employed professionals, net income was calculated as a percentage of gross receipts. Exemptions were given to the individual taxpayer, his spouses (a Muslim husband was allowed to have four wives) and a maximum of 5 of his dependents. Prior to 1984, the exemptions allowed were Rp 156,000 for the taxpayer, Rp 156,000 for each legal spouse and Rp 72,000 for each other dependents related by blood, marriage or adoption, upto a maximum of 5 such dependents. On top of these, there was a long list of tax exemptions, including war allowance for the former members of the armed forces, profits from selling or transfer of inherited property, interest from savings accounts and time deposits both of which were mostly at state-owned banks. Dividend incomes of resident aliens from companies domiciled overseas were exempted from personal income tax. Credit was given for taxes paid abroad but only at rates at which the same income would have been taxed if earned in Indonesia.

There were four kinds of allowable deductions to calculate taxable income. First, contribution for pension funds taken from labor income at the maximum of Rp 168 thousand per annum or 10 per cent of gross income. Second, life insurance premium and pension fund contributions, not exceeding Rp 168 thousand or 10 per cent of gross income. Third, contributions to other forms of financial institutions designated by the Ministry of Finance, not exceeding Rp 168 thousand or 10 per cent of gross income. Fourth, a special deduction of at least US$ 9,000 per annum to foreigners who received labour income in foreign currency.

There were 19 marginal tax rates in the 1944 Income Tax Law, ranging from 10 per cent to 50 per cent for various taxable income classes (table 3). In addition, schedular rates were used to tax different items of income at different rates. Rental income and honorarium, for example, were taxed at the flat rate of 10 per cent, while other sources of income were taxed at progressive rates. Nearly all sources of income were subject to withholding.

Taxes on goods and services

Prior to reform, Indonesia had several types of taxes on goods and services: sales tax both on domestic and imported goods, excise taxes, and import and export taxes. The sales tax law was enacted in 1950 as a multistage turnover tax on delivery of goods and services (including imports) at the rate of 2.5 per cent. Services were not taxable under this law and tax rate for luxury goods was set at 10 per cent. The turn-over tax was later replaced by a single-stage tax at the manufacturing level to avoid the cascading effects of the turnover tax. Tax paid on raw materials and intermediate goods could be credited against the tax liability incurred by manufacturers on final goods, thereby further avoiding the cascading effect.

In 1959 and 1960, the Government introduced basic changes in the sales tax law. The basic rate was doubled to 5 per cent including the rate on essential goods. Tax credit arrangement was abolished and the sales tax on import was repealed. In 1966, the basic tax rate was

Table 3. Personal income tax schedule prior to 1983

Taxable income (in Rupiah)	*Basic tax (in Rupiah)*	*Percentage of each additional Rp 100*
0	0	10
200 000	20 000	11
400 000	42 000	12
700 000	78 000	13
1 000 000	117 000	14
1 400 000	173 000	15
1 800 000	233 000	16
2 300 000	313 000	17
2 800 000	398 000	19
3 300 000	493 000	21
3 900 000	619 000	23
4 500 000	757 000	25
5 100 000	907 000	28
5 800 000	1 103 000	31
6 500 000	1 320 000	34
7 200 000	1 558 000	38
8 800 000	2 198 000	42
9 600 000	2 566 000	46
Over 9.6 million	–	50

Source: The Directorate General for Taxes.

increased to 20 per cent, and to 50 per cent for some luxury goods. In 1968, sales tax on imports was reintroduced and tax rates reduced to 10 per cent with 20 per cent for luxury goods. A large number of raw materials, intermediate goods and services were however taxed at 5 per cent rate. The Government issued a long list of goods and services with different tax rates chargeable and also a list of exempted items. The multiplicity of rates thus introduced on different goods and services, created confusion, uncertainty and administrative difficulties that led to inadequate compliance and widespread evasion. Multiple taxation affected optimum factor combination and discriminated against the use of some kinds of materials or interme-diate goods.

Tax incentives

Prior to recent reforms, tax policy had also been used to encourage private investment, savings mobilization, and to affect trade structures. Various incentives were offered by the Foreign Investment Law of 1967 and Domestic Investment Law of 1968. The tax incentive scheme had several objectives: to promote high-priority sectors (especially domestic production of capital equipment and "upstream" industry), to increase employment, to promote balanced regional growth, and to promote non-oil exports. Trade structures were affected by taxing imports more heavily than domestic products. Exports of non-oil commodities were promoted by subsidy or tax preferences.

Various forms of tax incentives had made the pre- 1983-1985 tax system more complicated. The fiscal incentives, which made cost of capital cheaper, took the forms of tax holiday, tax credit, investment allowance and accelerated depreciation. In addition, imported

plant and machineries, and spare parts and raw materials for the duration of periods of trialruns were exempted from customs duty or other import taxes. The tax holiday subsidized firms as earnings from all of their activities were exempted from corporate income tax. The subsidy was proportional to profits regardless of whether they resulted from a large investment with low rate of return or from a small investment with a high rate of return. On the other hand, tax credit was linked to the size of investment regardless of the rate of profit.

The fiscal incentives were linked to multiple, and sometimes conflicting, objectives. These included the size of invested capital, employment creation, contribution to exports, demand for locally produced inputs, technology transfer, contribution to technical change in case of pioneering industries, and contribution to regional and remote area development. As most of them were not clearly defined, they were subject to discretionary interpretation of the executing officers in charge.

One of the confusing interpretations was in regard to employment creation. First, in general, it was interpreted, as one in a one sector model with fixed coefficient of capital to labour, implying that the larger the capital stock, the greater the demand for labour. Second, too much emphasis on employment creation sometimes diverted an incentive programme for other objectives. Third, subsidization of employment induced firms to increase employment temporarily just for the duration of the tax holiday. Fourth, it induced firms to expand vertically to incorporate processes not otherwise eligible for the tax relief. Fifth, it also induced them to create subsidiaries for horizontal expansion and other activities. Sixth, it tended to widen the gap between wages in the subsidized modern sector with those in the unsubsidized traditional sector of the economy. Typically, wages in the former sector exceeded wages in the latter because the modern sector was organized, required higher skill, or because of the barriers which impeded movement of workers from one sector to another.

Fiscal incentives also created distortions in financial markets. Prior to the 1983 income tax reforms, the authorities offered generous incentives for companies to sell equities in the Jakarta Stock Exchange (JSE) as well as to the investors in this capital market. The incentives to companies included assets revaluation for the purpose of depreciation and other tax incentives. The latter included exemption from stamp duty, and of capitalization of reserves derived from retained earnings or undistributed profits. A company which sold at least 15 per cent of its shares was eligible for tax relief on revaluation of fixed assets, which was normally levied at the company tax rate.

The investors in JSE were entitled to the privilege of no tax inquiries into the origin of a maximum of Rp 10 million of funds invested. The investment was tax deductible and free from property tax, and the yields as well as the capital gains were also exempted from income tax. Shareholders and holders of share certificates of Indonesian nationality were granted full relief from corporation tax, income tax, and tax on interests, dividends, and from royalties with respect to profits gained from sale of shares and any dividend received within a period of 24 months after a company was listed at JSE.

Nevertheless, the pre-1983 income tax was biased against investment in securities as investment in these instruments were subject to a 15 per cent withholding tax. On the other hand, interest income in rupiah deposits were tax free. This and the policy of tying the rate

of gross returns on securities to interest rates of rupiah deposits at state-owned banks, had made investment in securities unattractive. Before these were corrected in October 1988, these distortions continued even under the 1983 income tax legislation.

The fiscal incentive schemes were biased toward large firms. The implicit and explicit administrative costs to obtain the facilities were beyond the reach of medium- and small-scale firms. The cost was particularly higher for those located far away from the capital city as the administration of the incentives was centralized in either at the head office of the Directorate General for Taxes or the Investment Coordinating Board, both located in Jakarta.

Tax holiday schemes were beneficial to firms that invested all at once before commencing production. It was also beneficial to firms with greater proportion of the total return accruing in the short-run during the period of tax holiday. However, tax holiday was biased against long-term investment with greater proportion of the total return accruing after the end of the tax holiday. Tax credit scheme was more neutral as the credit would be valid regardless of when the investment occurs or when the returns accrue.

Tax administration

The complicated corporate and individual income tax laws of the pre-1983 period demanded big, competent and efficient tax administration. As the existing tax machinery had no such qualifications, the Government introduced both the self-assessment scheme and tax withholding systems in Act No. 8 of 1967. The systems were applied to corporate and personal income as well as wealth taxes. They were not applicable however for receipt from the sale of fertilizer, and from transactions exempted from taxation under the domestic and foreign investment laws.

The self-assessment system was applied to income, corporate and wealth taxes. The withholding scheme was applied to income and corporate taxes. Depending on the nature of the transactions, buyers or sellers or suppliers of services were designated as tax collectors. The purpose of the systems was strengthening tax coverage as well as to speed up their payments by collecting the taxes in advance at the time of transactions being made. The basic rate for the self-assessment scheme was 1 per cent, except for services which were subject to a 10 per cent rate. The basic rate for the withholding system was 2 per cent, but other rates were also applicable to certain commodities and activities.

Exports and imports were subject to the withholding system. The rates for importers were discriminated by the types of letters of credit (L/C), and their positions either as tax collectors or taxpayers. For normal L/C, the rates were 5 per cent for taxpayers and 3 per cent for tax collectors. For merchant's L/C, tax rates were 10 per cent for taxpayer and 6 per cent for tax collectors. Imports without L/C or merchant L/C, were subject to 12 per cent rate for taxpayers and 6 per cent for tax collectors.

As they were applied to all stages of transactions, the products were subject to several rounds of self-assessment and withholding. The multi-stage withholding was similar to the turnover tax which involved pyramiding and discriminating in favor of vertically integrated firms. Only when the manufacturers and importers themselves made the final sale was self-assessment and withholding applied only once. A further 2 per cent rate was imposed when the products were sold by the importers or manufacturers.

On paper, excess payments could be refunded or set off against other taxes. In reality, however, tax refund required a lengthy and costly procedure.

II. TAX REFORMS SINCE 1983

As the prospect for a slowdown in growth of oil tax revenue became clear in the early 1980s, the Government initiated a study for reforming the whole tax system in 1981, in collaboration with the Harvard Institute for International Development (HIID). The study was the basis for the new tax laws, enacted between 1983 and 1985. The first objective of the tax reform has been to generate public revenue from non-oil and non-foreign-trade sectors in reasonably efficient, equitable and sustainable manner. A second objective has been to reduce distortions in the incentive structures in order to improve efficiency and equity of resources allocation in the economy.

Self assessment, with the tax administration selectively auditing a sample of the returns, has been introduced as a major feature in tax administration in place of the old system which required an official assessment of each taxpayer. Other features of the new system include improved procedures for refunds and appeals with specific time limits for responses to the taxpayer. As discussed further in later sections, the new system brings simplicity, progressivity, certainty, and a closing of loopholes for tax evasion. At the same time, the new system reduces direct costs of administration.

Direct taxes

Income tax

Law Nr. 7 of 1983, which took effect in January 1984 (the Law was slightly modified in 1991), integrated the personal income tax and corporation income tax into one single income tax. The new structure is much simpler than the ones it replaced. The individual income tax base was sought to be broadened by subjecting more types of income and in-kind fringe benefits to taxation[1] and by reducing allowances, deductions, exemptions and tax expenditure provisions. Income was more broadly defined to include interest income,[2] dividend,[3] returns from bonds and other securities, and all prizes from lottery and gambling. All capital gains are to be taxed as ordinary income. Long-term gains (gained over one year) is prorated over the years in which they accrued and taxed accordingly. In the past, only short-term gains were taxed.

The new income tax law, however, provides incentives for savings through formal financial institutions and cooperatives. The law disallows certain deductions, such as: premiums

[1] With the promulgation of Law Nr. 7 of December 1991, all in-kind fringe benefits (such as food and lodging, transporation and health care) and housing facilities provided by the Government to its employees in remote areas were exempted from individual income tax.

[2] Until October 1988, interest on time deposits with resident financial institutions was exempted from income tax.

[3] Law Nr. 7 of 1991 exempts dividends received by domestic (state, private and cooperatives) companies from its local joint venture firms.

for life and health insurance unless they are paid by employers, gifts, personal expenses and contributions. Deductions are allowed for the following items: costs of earning, recovering and securing income; depreciation; contributions to approved pension funds; losses from the sale of transfer of property; and business profits of a cooperative exclusively from and for its members.

To help relieve the tax burden on the poor, the personal exemptions were raised substantially as shown in table 4.

Thus a family of five with non-working spouse would, in 1984, had an exemption of Rp 2.88 million, compared with Rp 1.05 million that it would have got under the old system. The amount of the personal exemption (Rp 960 thousand) was 1.8 times of per capita GDP in 1984 (Rp 531,720). With this amount of personal exemption, the income tax legislation was only applicable to a little over 10 per cent of Indonesia's population (1985: 164 million). Since 1984, two more adjustments were made in 1989 and 1993 in individual tax exemptions, as relief to taxpayers against inflation. The percentage change in tax exemptions was higher than that of cumulative inflation rate during 1985-1988, thus reducing real effective tax rate. On the other hand, the change was half of the cumulative inflation rate during FY 1989-1992 so that the real effective burden of taxation tended to increase.

Through a simpler tax structure, more certain and well defined, with fewer loopholes for tax evasion, it was hoped to achieve greater compliance and a more efficient tax administration as keys to improved tax yield. Virtually all special tax incentives for investment have been eliminated and allowable deductions have been narrowed, but these are compensated for by lower tax rates and more generous depreciation regulations. Non-deductible expenses include amounts paid as dividends, premiums for life and health insurance unless paid by the employer, excessive compensation paid to shareholders for work performed, gifts,

Table 4. Individual tax exemption, 1984-1993
(In thousand rupiah)

	1984	*1989*	*1993*
1. Individual taxpayer	960	1 440	1 728
2. Additional exemption if taxpayer is married	480	720	864
3. Additional exemption for a working wife engaged in business, work not related to that of her husband or any family member	960	1 440	1 728
4. Additional exemption for each dependent, up to a maximum of 3 individuals	480	720	864
Memo:	FY 1985-1988		FY 1989-1992
1. Percentage increase in tax exemptions	50.0		20.0
2. Inflation rate (per cent):			
(a) Annual average	7.3		8.6
(b) Cumulative	23.7		40.7

Source: The Minitry of Finance. Directorate General of Taxation and Bank Indonisia, *Weekly Report*, various issues.

personal expenses and contributions. In-kind payments made to employees such as company houses, business automobiles and holiday leaves are also not deductible. Investment incentives in remote areas are however given in forms of more generous depreciation and exemption of in-kind payments from individual income tax.

Depreciation regulations have been simplified. The basis of depreciation is acquisition cost and useful life of the assets. For the purpose of computing depreciation, the depreciable properties are classified into four categories. The first three categories are intangible assets. Formation and capital expansion costs of intangible of class 1 can be amortized at a rate of 50 per cent per year. The cost or value of acquiring mining (other than oil and gas) and timber rights can be amortized using the "production method" with a limit of 20 per cent per year. The cost of acquiring other rights with a useful life of more than one year can be amortized using the production method with no yearly percentage limitation. This rule is also applicable to oil and gas.

The rate schedule of income taxation, applicable both to personal and corporate income, has been greatly simplified and reduced to only three as follows:

Not exceeding Rp 10 million	15 per cent
From Rp 10 million to Rp 50 million	25 per cent
Over Rp 50 million	35 per cent

These rates are lower at almost every level of income than under the previous tax system. The 1983 income tax law allows the authorities to index the rates to account for inflation (the annual index factors will be announced by the Minister of Finance).

Reform of property tax

The old property tax consisted of seven laws covering separate taxes on land, road, wealth including liquid and illiquid assets, and several other assets such as furniture and other durable goods. The laws were complicated and difficult to administer because they were contradictory and overlapping to other taxes. Except the "Ipeda", or land tax, this group of property taxes produced low revenue collections. The share of revenue collections from agricultural land had been falling while that from urban and forest lands rising. This was due to more rapid rates of growth of land values and property rentals in major urban centers, and increase in the number of logging and forest based industries since the late 1960s.

The new property tax law, which came into effect on 1 January 1986, replaced all of the old laws governing taxes on land and property. It stipulates a single rate of 0.5 per cent of taxable value of the properties. Taxable value is set between 20 and 100 per cent of the market values of the land. However, only two fractional bases have so far been used for poverty tax assessment under the new law. For property with market value below Rp 1 billion, effective from 18 March 1994, the tax liability is calculated on 20 per cent of the sales value to make the effective rate at one per mil of its sale value. For property with sales value above Rp 1 billion, the tax base is doubled to 40 per cent of its sale value to make the effective tax rate at 2 per mil of its sale value. In principle, the sale values is determined once in three years. In areas where prices tend to rise markedly within a short period of time, the sales value might be determined more often.

To make the property tax more progressive, buildings valued less than Rp 2 million was exempted from the tax. The value of non-taxable land was raised to Rp 3.5 million in April 1989. Exemptions of a maximum 75 per cent of tax liability can be given to fixed income groups (such as civil servants and veterans), and in case of natural disasters. The law and its procedures are made simple and easy for taxpayers to understand and to comply with and, at the same time, easy for tax administrators to administer. Collection of property tax is entrusted to provincial and local governments, which are in a better position to identify taxpayers and estimate the tax base.

Prior to Fiscal Year 1994/95, the proceeds from land and property tax was allocated as follows: 19 per cent retained by the central government of which 9 percentage was regarded as collection costs. The remaining 81 per cent was shared by lower-level governments of their origins, of which 16.2 percentage was received by districts and municipalities, and the remaining 63.8 percentage received by provincial governments. Starting from Fiscal Year 1994/95, the 10 per cent net share of the central government is also distributed to the districts and municipalities of their origins.

The property tax is imposed at an ad valorem rate on the market value, and the unimproved capital value (also known as site value). In reality, it is very difficult to estimate property values in Indonesia. At present large tracts of land are unregistered and the vast bulk of it is owned, controlled and administered by the State for the common good. The allocation of state-controlled land is subject to a cumbersome and lengthy procedure. There is no complete and reliable information or records on land and property holdings and market values, annual income and expenses on property, land surveys, topography and other physical factors. Because of these reasons, the potential of property tax is far from being realized.

Indirect taxes

Introduction of the VAT

The consumption type of VAT law was enacted in 1984 and became effective on 1 April 1985. This law replaced the old sales tax which had six different rates ranging from 1 to 20 per cent. In theory, the VAT improves both fiscal and economic efficiency since it takes only a portion of the value added at each stage of production. The VAT contains built-in or self policing measures since false accounting of sales by under-invoicing should be rejected by the buyers whose tax liability would be increased by such an action. Because of its built-in self-enforcing mechanism, the VAT is a reliable generator of revenue and incurs relatively small efficiency losses.

The basic VAT rate is 10 per cent and can be reduced to 5 per cent or increased to 15 per cent for certain goods. In reality, Indonesia uses a single uniform rate of 10 per cent. Exports are zero-rated since VAT is only applied for domestic consumption. The VAT rate is applied to the selling price of domestically produced goods and services, and to the import price plus all import duties and custom charges on imported goods. When the VAT was introduced on 1 April 1985, taxpayers were limited to manufacturers or importers of taxable goods and services. The tax was extended to include wholesalers in January 1989, and large retailers (whose annual turnover is above Rp 1 million) in 1991.

Initially, the VAT was also limited to a short list of services. These included architectural services and other services related to the construction and property businesses. Effective from 1 April 1988, the list of VAT was extended to include 13 groups of services, and in April 1989, further to 21 additional services. Beginning January 1994, 28 groups of services were added to the list of VAT. These include oil and non-oil mining activities, leasing, legal, consultancy, accounting, data processing, maintenance and repair of machineries, advertisement, cleaning services, land clearing, pest control, cold storage, security services, travel agency, forwarding, harbour and airport services, and entertainment business. Oil and non-oil mining activities, however, was temporarily excluded from the list of VAT in 1989.

Some goods and services are exempted from value added tax. These include low cost housing, printing of money, government imports for the armed forces and other imports financed by foreign aid and loans, potable water, animal feeds, import of machineries, spare parts and equipments and products produced by state-owned strategic industries, imported components of land, sea and air transportations to be used as public transportations and trawlers, certain imported capital goods to be used by hotels, office buildings and shopping centers.

The VAT can be regressive since people in the lower-income group tend to consume a higher proportion of their income than do those in the middle- and upper-income groups. The authorities introduced three measures in order to address the regressiveness of the VAT. First, to exempt goods and services that account for a substantial fraction of the expenditures of the low income group from the VAT base. Products such as low-cost housing, ground transportations, and goods and services produced by the informal sector, and unprocessed food, are exempted from the base of VAT.

Second, small firms (those producers and traders of goods with an annual gross turn over of less than Rp 120 million, and providers of services with annual gross turnover of less than Rp 60 million) are exempted from the VAT. Administrative constraints also led to exclusion of such firms from the VAT. Initially, exclusion from the VAT was based on the placement of firms in the production and marketing chain, such as main distributors and principal agents. This, however, had resulted in inadequate revenue collections, particularly as producers bypassed the tax by selling to related distributors. Because of this, the authorities extended the VAT to the wholesale stage starting from 1 April 1989.

Third, in addition to the VAT, a non-creditable special sales tax of 10, 20, 25 or 35 per cent is imposed on specified luxury goods, and products that are considered socially undesirable. The rate of 25 per cent is applicable for automobiles using solar fuel. Special levies of sales tax on luxuries and highly priced consumer durables (such as jewelry, golf sets, luxury electric and gas appliances, photographic equipments, motor vehicles, crystal and marble made products) partly addressed the regressivity of a single-rated VAT. Domestic sales of petroleum products (which was exempted from sales tax earlier) and tobacco products (which were already liable to excise taxes) are now subject to VAT. Inclusion of these products as VAT objects has increased revenue potential.

The introduction of the VAT has eliminated the economic distortions arising from the cascading effects of the former multi-rate sales tax. To neutralize bias between importables

and exportables, the VAT is not imposed on exports and a full refund of import taxes is granted for exported goods.

Excise tax reform

Excise taxes are still imposed on some goods such as alcoholic beverages, sugar and tobacco products. Since 1988, a 10 per cent rate has been applied to alcoholic and non-alcoholic beverages and sugar. In 1988, the rates for tobacco products were changed to the following schedule:

Mechanically produced cigarettes	20 to 37.5 per cent
Non-mechanically produced cigarettes	5 to 17.5 per cent
Cigars	12.5 per cent
Incensed-flavor cigarettes	5 per cent
Cut-tobacco	5 to 17.5 per cent
Other tobacco products	5 to 7.5 per cent

In addition to import duty and sales tax, imported tobacco products are subject to the excise tax. At present, a 40 excise tax is applied to imported cigarettes and a 20 per cent rate is applied to imported cigars.

Reform of import tariffs

Along with non-tariff barriers, import duty has been used by the Government as a major tool to achieve its multiple objectives, such as: to raise revenue, to curb luxury consumption, to allocate economic resources, to shield domestic activities from foreign competitions, and to promote non-oil exports. To some extent, the Government has also used import policy to maintain domestic stability and balance of payments equilibrium. To help sterilize "oil money", the Government had encouraged imports in the early 1970s by lowering tariff rates. However, since 1982 the Government had reversed its import policy by erecting non-tariff barriers, because tariff was considered inadequate to protect upstream industries, as well as to improve the balance of payments position that worsened owing to the decline in the price of oil. This policy switched demand towards home-produced goods and at the same-time reduced overall domestic absorption. Such import restrictions, however, had changed not just the level of protection but also the structure of protection with adverse income distribution effect on consumers of the protected goods as well as long-term adverse effects on efficiency of resource allocation and growth. Such policies also caused business climate to deteriorate that reduced private investment.

To pursue the various above objectives, Indonesia had also adopted an overly complicated split tariff system. On top of nominal tariffs, some imports were subjected to surcharges and others to administrative exemptions. The exemptions were given for three main categories of imports. The first category are capital goods and raw materials for start-up operations of projects approved by the Investment Coordinating Board and for oil and gas projects administered by the Ministry of Mines and Energy, and Pertamina – the state oil company. The second category are eligible imports under the duty-drawback or exemption scheme for exports, administered by *Bapeksta* at the Ministry of Finance. The third category are imports specifically exempted by the Ministry of Finance.

Along with the reforms of the incentives and investment licensing regime since the mid-1980s, the Government has reduced both the effective rates of protection and their variations (table 5). The relaxation of non-tariff barriers has made tariff playing a more important role in determining both the level and pattern of imports. Starting from January 1989, Indonesia has adopted the Harmonized Commodity Description and Coding System (HS), replacing the Brussel Tariff Nomenclature (BTN) or the Customs Council Nomenclature (CCN).

The Presidential Decree Nr. 4 of 1985 terminated the use of check price system as a benchmark to calculate import duty. Prior to this, the system of check price served two purposes: first, to reduce the extent of under invoicing occurring at customs and, second, to alter the level of protection without changing the tariff.

The policy to lower the levels and dispersion of tariffs and overhaul surcharges has been more consistent between 1989-1991. The elimination of split tariffs and legal exemptions in 1991 has improved the transparency of the tariff schedule. Since then, the tariff ceiling has ranged between 30 and 35 per cent, with 83 per cent of all items at or below this range. Over half of production in import-competing sectors is protected by tariffs of less than 10 per cent.

Reduction in and consolidation of tariff rates proceeded along with a shift from non-tariff barriers (NTBs) to tariffs. The share of imports subject to NTBs had been gradually reduced from 43 per cent in 1986 to 13 per cent in 1991. During this period, the proportion of domestic production protected by NTBs declined from 41 to 22 per cent.

Export tax and regulations

Export taxes have been used generally to protect industries processing or fabricating raw material for exports or domestic use, to conserve resources, to improve the quality of exports through heavy taxation of low grade export products, to generate government revenue and to exploit monopoly position in international market. To some extent Indonesia has pursued those objectives, particularly to encourage investment in resources based industries and to

Table 5. Changes in tariff schedule, 1985-1992
(Average tariff rates including surcharges, in per cent)

	pre-1985	*1985*	*1988*	*1989*	*1990*	*1991*	*1992*
Unweighted	37	27	24	27	22	20	20
Weighted							
* By import value	22	13	15	12	11	10	9
* By domestic production	29	19	18	19	17	15	13
Index of dispersion[a]	62	108	90	93	89	83	83
Average effective tariff[b]	n.a.	4.9	5.1	5.4	6.2	4.5	4.8

Source: Country Department III-East Asia and Pacific Regional Office of the World Bank, "Indonesia Growth, Infrastructure and Human Resources", (1992).

[a] Coefficient of variation of unweighhted average tariff including surcharge.
[b] Revenue from import duties in relation to non-oil imports (fiscal year).

generate revenue. In January 1989, the taxable export goods were classified into six groups and subjected to 0, 5, 10, 20 or 30 per cent rate of taxation. The taxable products included rubber, palm oil seeds and woods. In the case of wood-based products, export levies are specific amounts in US dollar per cubic meter.

However, exports of important products such as copra, logs, palm oil seed, and raw and semi-processed rattan have been regulated by export bans and quotas imposed at different points of time since the mid-1960s, thereby reducing the importance of export taxes both as regulatory devices and as a revenue source.

Reform in tax administration

The 1983-1985 tax system (covering income, value added and wealth taxes) has raised effective tax base by reducing tax avoidance and evasion. The new income tax law is based on self assessment, with the tax administration selectively auditing a sample of the returns. With greater simplicity and clarity in income tax law and procedure, taxpayers now can detect and act against arbitrary behavior by the tax authorities. On the other hand, the authorities themselves are better able to resist demands from taxpayers for exemptions and exceptions. Computerization of the processes contributes to further depersonalization of tax administration. This reduces collection costs for transferring resources to public sector and minimize the scope of corruption in tax compliance, collection, and refund.

The new tax system includes improved procedures for refunds and appeals with specific time limits for responses to the taxpayers. At the same time the new tax system reduces direct costs of administration. The progress in the implementation of VAT is similar to that of the income tax legislation. Large firms are quite enthusiastic about the VAT since it is less complicated than the former sales tax. However, for firms which have no good records and administration, filing the VAT returns is more burdensome.

The full implementation of the tax legislation, however, requires improvements in the tax administration and the legal and regulatory infrastructure. The former includes arrays of administrative activities, such as registration of taxpayers, tax assessment, collection procedures and audit.

Registration of taxpayers

The Government has adopted various measures to increase the number of taxpayers. Before being implemented, the authorities increased public relation activities to raise the level of public understanding and educate them about the technicalities of the 1983-1985 tax legislations. In the case of VAT, the public campaign was started one year before its implementation. During this period, the authorities also sought cooperation from taxpayers (businessmen, manufacturers, and traders) by taking into account their suggestions. The authorities also organized test runs to try out the new VAT during the campaign period. The public campaign activities was rented out to ***Yayasan Bina Pembangunan,*** a non-profit organization run by journalists and academics.

Under the system that emerged income, property and VAT taxpayers must register and obtain tax identification numbers, at their local tax offices. To increase the number of income

taxpayers (both individual and corporate), the 1983 income tax legislation revised the withholding tax system; a tax amnesty was announced in 1984 and extended to 30 June 1985. Public servants are required to obtain their tax numbers and, depending on their rank, report their tax returns to the President and the Ministers. As part of tax campaign, annual awards to 200 largest individual and corporate taxpayers at national level and 750 at regional level, and fifty each from regional tax offices, were announced.

Employers are required by the Income Tax Law of 1983 to withhold tax on wages, salaries, or honorarium at the time of payment which may be credited against the final amount of tax payment. Corporations are required to withhold tax at a rate of 15 per cent on domestic payments of dividends, interests, rents, and royalties. All foreign payments are to be subject to 20 per cent withholding. This payment is regarded as a final settlement of tax liability. The withholding tax schedule is shown in table 6.

The number of VAT taxpayers increased gradually with the enlargement of the list of tax objects. Information on property tax is updated through land surveys, mappings, and reclassification. The priority for these activities was given to 35 large cities, modern plantation, mining and forestry. Since 1986, productive (on and off-shore) and service land used by oil companies have also been subject to property tax. In 1993, the area of land that could be potentially subject to property tax was an estimated 79,416,237 hectares in 62,061 villages throughout Indonesia. Of this, 54,291,979 hectares (68 per cent) were taxed.

Table 6. Withholding tax schedule

Kind of income	*Withholding tax rates*
Income received by a resident	
Wages, salaries, honoraria	15 to 35 per cent
Income derived from carrying on business as an importer	2.5 per cent of import value for licenced importers and 7.5 per cent for unlicenced importers
Income derived from doing business with the government	1.5 per cent of gross amount
Interest, dividends, royalties, rents, technical and management fee	15 per cent of gross amount
Income received by a non- resident	
Payments made by domestic corporations to non-residents in forms of:	20 per cent, but where tax treaties are in effect with the country of residence of the recipient, a lower rate of withholding rate of 15 applies.
– dividends;	
– interest income including loan guarantee;	
– rents, royalties and other income for the use of property;	
– compensation paid for technical services, management services; and other services performed in Indonesia	

Source: The Ministry of Finance, Directorate General of Taxation.

The number of taxpayers have also gradually increased with the improvements in the collection of information and expansion of tax collection points in the modern sectors of the economy. The Directorate General of Taxes has made use of all available information from the registrars of land, cars and other transport vehicles, from companies, passports offices, and agencies such as the National Land Agency **(BPN — Badan Pertanahan Nasional)**, the Ministries of Justice, Trade, Mining, Forestry, and other government institutions. Information are also being collected from state-owned enterprises, cooperatives, and private sector companies. The Directorate for Taxes also collects information from the list of subscribers of telephones, electricity and other public utilities, passport holders, land owners, company owners, registered lawyers, public accountants, licenced consultants, car owners, public notaries, securities holders, users of bank services, Board of Supervisors and Directors of the registered companies and winners of state-lottery.

A modern tax system requires good financial records. Most of income, VAT and wealth taxpayers in Indonesia, however, have no such records. These add to the problems for the implementation of tax reforms. Withholding system and the exemptions of small firms and land owners only solved part of the problems. Most of the labour force are self-employed or employed by medium and small scale enterprises in the unorganized sector with poor record keeping. In a typical surplus labour economy like Indonesia's, a person engages in many activities either seasonally or permanently, and turnover rates are very high in such non-organized sectors making it difficult to extend the tax measures to the largest segment of the population.

Part of many firms' productions and sales are for self consumptions by the owners who concurrently contribute labour services to the firms. Especially those dealing with cash sales in more or less street market conditions without using tills, find it difficult, if not, impossible to keep records of their gross taking. Under such conditions, a producer and trader can also provide services along with goods, or as a quite separate activity. Medium and small scale firms mix owners and business assets and liabilities. On property, most of the private-owned land are unrecorded, unregistered, and the ownerships are subject to local tribal customs.

Prior to 1 January 1989, value added and sales taxes were collected only by the office of the treasurer of the central government. Since then, the collectors of these taxes have been expanded to include the offices of treasurers of the provincial and district governments, Pertamina – the state-owned oil company, Bulog – the Logistic Agency, and the state owned and regional development banks are owned by provincial governments. A strengthening of cross-checking and auditing procedure, along with an extension of coverage to retailers with turnover of more than Rp 1 billion as of January 1992 also helped increase the number of taxpayers and buoy receipts from the value-added tax.

The extended efforts have increased the number of taxpayers as shown in table 7.

In 1992 alone, the number of registered taxpayers for corporate income tax and for personal income tax rose by 6.1 and 17.6 per cent, respectively. In the same year, the number of unregistered taxpayers, i.e, those reported earning income only from one source subject to withholding by the employer, rose by 17.7 per cent. At the same time, the number of VAT, and land and property taxpayers grew by 17 and 2.6 per cent, respectively.

Table 7. The number of taxpayers by main categories of taxes, 1982-1993

Kind of taxes	*1982*	*1985*	*1987*	*1989*	*1993[a]*
Income tax	306 996	446 836	800 626	1 131 381	1 720 481
Individual	247 361	343 847	643 042	703 061	948 888
Corporate	59 635	102 989	157 584	428 320	771 593
VAT/Sales tax	119 499	69 942	72 658	85 976	234 547
Property tax	n.a.	n.a.	n.a.	36 398 955	40 437 297

Source: The Directorate General for Taxes, "Reports for Pelita II to Pelita IV and fiscal year 1992/93".

[a] 1992 for land and property tax.

Tax assessment and audit

As has been discussed earlier, the 1983 income tax law puts reliance on self assessment and the 1984 VAT law relies on a built-in mechanism through cross-checking of sales/purchase invoices for tax assessment and collection. Under such systems, the role of tax administrators is more of assisting the taxpayers to fill the income and VAT tax returns rather than to assess each taxpayer. The tax administration, however, is selectively auditing a sample of the returns. Investigation is concentrated to those who claim refund of excess payments of taxes and those who report losses. Based on standard criteria, the sample is drawn and audited by local tax offices. To minimize bookkeeping burden on small companies (those with turnover of less than Rp 60 million), they can elect to have their tax liability determined by special norms. Such companies need only keep records of gross turnover. The standard price or base to calculate property tax is adjusted periodically every three years.

Payments and refunds

Like the income tax, the VAT is basically a self-assessed tax. Registered taxpayers are expected to submit their payments with the completed assessment forms. To improve collection efficiency and provide better service to taxpayers, tax returns and payments are processed locally, and refunds are processed regionally. Taxes are collected by local authorized agent banks, which have an incentive in that they get a week to use the money before they are transferred to the government account. Banks stamp all copies of the returns showing the date of receipt. The only problem, however, is that the receipt has to be validated by the local tax office to serve as evidence of the tax paid. Late validation of tax receipts is fined.

The service to taxpayers has also improved as tax refunds are processed at Regional Tax Offices. Two Presidential Decrees were issued on 10 October 1985 to authorize the Directorate General for Taxes to refund excess payments of taxes and to solve the problems of over-withholding of the income tax and the value added tax for exporters at the source. The decrees empowered the tax authorities to give refunds in respect of tax years prior to 1984 without auditing as a special concession, but refunds in respect of 1985 onwards require audits. High penalties would be imposed on those whose claims for refunds proved unjustified after audit. To speed up the tax refunds, the payments can be made through state banks rather than

only through the national cashier offices of the Ministry of Finance, as was the case earlier. The speedy tax refund is expected to improve equity of the tax system, and thus compliance.

Administration of taxes on external trade

As has been discussed before, Indonesia adopted a complicated split tariff system and a two-tier imports inspections system. The system represented a double distortions in the sense that domestic activities were protected from imports and, at the same time, non-oil exports were subsidized. Deregulation has only reduced the levels of the effective rates of protection and subsidies by reducing nominal tariff rates, surcharges, and the coverage under non-tariff barriers. In addition, the authorities have also reformed customs inspections procedure to shorten delays in and lower costs of customs clearings.

Presidential Instruction **(Inpres)** 4 of 1985 transferred the responsibility for checking imports and exports over US$ 5,000 from the customs service to SGS – Societe General de Surveillance – a Swiss based private inspection firm. As the SGS contract was ended in 1990, the inspections tasks, since 1991, have been gradually transferred to PT Surveyor Indonesia, a joint venture between PT Sucofindo, a state-owned inspection company, and SGS. By April 1994, PT Surveyor Indonesia has established 10 overseas branches and taken over about 50 per cent of the inspection tasks from SGS. Inspections are done at site before shipments. Shipments below US$ 5,000 go through customs.

The complicated tariff structure and two-tier inspections give incentive for importers to split imports and bargain with customs to lower the assessed duties and taxes. The power of the Custom Service was partly restored as it was granted authority to check both exports and imports if there are grounds for suspecting that incorrect declarations have been made. A time limit for the procedure is set for 4 working days. The import subject to preshipment inspection has steadily declined from 70 per cent in 1988 to 47 per cent in 1992.

Exemption of import tariffs are administered by four agencies. The Investment Coordinating Board approves exemptions for imports of capital goods, spare parts and raw materials for start-up operation of approved investment projects. *Bapeksta,* an agency at the Ministry of Finance, approves eligible imports under the duty-drawback or exemption scheme for exports. The Ministry of Mines and Energy approves exemptions for equipments to be used by oil and gas based projects. The Directorate General of Customs administers exemptions for imports specifically exempted by the Ministry of Finance.

Information system

The Ministry of Finance (MOF) was the first ministry in Indonesia to use modern technology for storing and processing information at the Center for Analysis and Financial Information **(PAIK – Pusat Analisa dan Informasi Keuangan)**. Established in the mid-1970s, the computer center at PAIK collects, stores and processes financial transactions of the central government. Established in 1984, the Center for Data Processing and Tax Information of the Directorate General for Taxes (DGT) has its own computer center to store and process information on income, VAT and wealth taxes and stamp duty. The mainframe at DGT is hooked to the computer center at PAIK. In March 1993, the DGT computer center has two CPU IBM mainframes. Each tax office is equipped with a separate micro computer or work station. Tax

assessors and inspectors are also equipped with personal and laptop computers. Because of the expensive telephone lines, not all of the small units are electronically connected to DGT computer mainframe. Data are transmitted from tax offices to DGT computer center via tapes, diskettes, disks and cassettes.

For software, at present, DGT uses user and application package programmes which are commercially available at low prices in international markets. Experienced computer technicians and programmers are lacking in Indonesia. DGT now has application systems for Master File of Income, VAT and Wealth Taxpayers, Control and Tax Payments, Processing of Income Tax Returns, Processing of VAT tax returns, Processing of Withholding Tax, Audit Selection, Tax Audit and Control, Data Comparative, Master File on Tax Personnel, Processing and Monitoring of Tax Refunds, Processing and Monitoring of Tax Appeals, Processing on Insurance, Taxpayers' Compliance Measurement Program, Taxpayers' Debt Equity Ratio. Modifications of these computer programmes to Indonesian conditions are being made with the help of foreign consultants at DGT, mainly from Germany and the United States.

The computers have been useful tools of tax administrators to reduce the costs of operations, collection, storage and processing of information on income, wealth and VAT taxes, improve the efficiency of controls, and assist taxpayers to comply with tax laws. The computers are being used to process taxpayer registration, returns, and payments. They are also used to assist in other compliance and enforcement areas such as collection and auditing. Depersonalization of tax administration minimizes corruption and arbitrariness in tax compliance, collection and refund.

In general, the quality of the tax information in Indonesia is, relatively poor however. This is mainly because of the relative underdevelopment of its accounting and legal systems. Good records are available only in large companies, particularly multinational corporations. Such limited availability of credible financial statements has affected implementation of tax reforms.

The present corporate tax laws require that "adequate financial records be kept", but do not impose accounting requirements and standards to ensure financial disclosure. Financial institutions are required to file audited financial statements to Bank Indonesia, the central bank, and to publish them quarterly in major newspapers. Following the October 1988 financial sector reforms, Bank Indonesia, in cooperation with the Association of Indonesian Accountants, has issued special standards for Indonesian banking accountancy. This reduces off-balance sheet transactions and has standardized the financial and operational reports of banks.

The current company law in Indonesia is based on the antiquated with 21 rudimentary provisions of the 1887 colonial Commercial Codes. It takes a long time to resolve cases as the courts are overburdened and understaffed while the procedures are complicated and slow. All types of cases go to general courts and judges, as there is little specialization among them. In particular, the technical competence of attorneys, judges and lawyers is relatively weak in handling cases on taxation. Basic Law on the Judiciary, (No. 14 of 1970), which governs the courts, emphasizes the principle of independence of the courts and prohibits outside interference in judicial matters. In reality, however, the administration of the court system is under the jurisdiction of the Ministry of Justice through control over budget, and posting, transfer and promotion of judges as they are career civil servants. This, combined

with the lack of technical competence, fraud and corruption, erodes confidence in the fairness of the trial process.

Administrative organization and human resources

The Directorate General for Taxes is under the Ministry of Finance, the most powerful institution in the Government of Indonesia. The Ministry of Finance is not only in charge of financial management of the central government. As the Chairman of Monetary Board, the authority of the Minister of Finance is extended to the economy as a whole. The Ministry of Finance collects tax and non-tax revenues and allocates government expenditures. Some of the Ministry of Finance's power in budget allocation, however, is shared with the Planning Agency **(Bappenas)** which controls allocation of the "development budget".

The Ministry of Finance consists of ten powerful Directorate Generals and Authorities, namely: Customs and Excises; Taxes; Budget and Treasury; State-Owned Enterprises; Financial Institutions; Capital Market Agency; the State Recovery Agency; Bapeksta – which administer the duty-drawback or exemption scheme for exports, Research and Development which also controls PAIK, and Education and Training which coordinates all training programmes for the Ministry of Finance. Prior to the present structure, the Directorate Generals for State-Owned Enterprises and Financial Institutions were under the Directorate General for Monetary Affairs. The former responsibilities of Directorate for Monetary Affairs in administering foreign aid and loans and non-tax revenues and collecting taxes from oil companies, have been transferred to the Directorate General for Budget and State Treasury. Directorate General for Customs and Excises collects import and export taxes and excises. Directorate General for Taxes collects income taxes, taxes on domestic transactions, property taxes, stamp duty and other taxes.

The present Directorate General for Taxes is a merger of various agencies: the Tax Office, the State Auction Office, the Tax Accounting Office, and the Office of Land Tax. The State Auction Office – which takes over the assets of tax delinquents and sell them to recover taxes due – joined the Tax Office in 1962. The Tax Accounting Office, which had the responsibility to audit and investigate corporate income tax, joined the Directorate General in 1965. On 27 March the Office for Land Tax was transferred from the Directorate General for Monetary Affairs to the Directorate General for Taxes.

To implement the 1983-1985 tax laws, the Directorate General for Taxes was reorganized on 10 December 1988 and on 3 August 1993. Since 1988, the head office consisted of 1 Secretariat, and 8 Directorates: Tax Legislation; Income Tax; Value Added Tax and Other Indirect Taxes; Land and Buildings; Revenue Planning and Claims; Regional Control and Investigation; Data Processing and Information. The new Directorate for International Relations was added in 1993. The Directorate General is headed by a Director General, the Secretariat by a Secretary and the Directorates by one Director each.

To cover wider effective tax base, the number of Regional Tax Offices was expanded from 12 to 15 on 1 April 1989. Of these, the Greater Jakarta Region alone has three regional offices. One of the Jakarta Regional Tax Offices serves state-owned enterprises located in the capital city and supervises all tax offices which deal with foreign firms throughout the country. The regional tax offices supervise 140 tax offices scattered in Indonesia and 42 of these are class A and 98 are class B. All of the 30 tax offices are Class A. Class A tax office

is headed by senior official and a Class B by a middle rank manager. Prior to 1 April 1989, the number of tax offices was 120. The numbers of tax collectors for each type of taxes (income, value added, and property), auditors, promoters and educators may not be the same in all offices and, are determined, among other things, by local tax potential. The number of employees of the Directorate General for Taxes gradually increased from 18,835 on 31 March 1984 to 19,332 on 31 March 1989 to 19,391 on 31 March 1993. At present, 1.4 per cent of the employees are at the head office, 6.6 per cent at the regional offices, 58.5 per cent at local income and VAT tax offices, 26.7 per cent at local land tax offices and 7.8 per cent at local tax auditor offices.

Tax officers went to intensive retraining programmes both in house and overseas before the 1983-1985 taxes were introduced. DGT has two in-house training programmes, namely: The Technical Training Programme for basic technical training, and The Center for Tax Training for more advanced courses. The programmes offers technical courses on tax laws and regulations, assessment, collection, administration, audit and investigation. The programmes also offer courses in how to use the computer tax packages. New recruits and tax consultants from the private sector are required to go through these programmes.

The quality of human resources at the Ministry of Finance, including DGT, is increasing as it is the leader in sending the talented and bright young staffs to go for further study overseas, mainly to the United States and Western Europe. The density of the holders of Ph.D and Master degrees in various fields of economics and law at MOF is the highest among the Ministries outside the Ministry of Education and Culture. DGT also sends its people to short-term training courses in taxations, and for on-the-job training all over the world.

DGT also receives transfer of technology through various forms of technical assistances from various foreign institutions. A group of experts from **GTZ – Deutche Gesellschaft Fuer Technische Zusammenarbeit** of Germany – has been helping DGT since 1978. Cooperation with the IRS – Internal Revenue Service of the United States – started in 1986. On top of these, DGT receives technical assistance from ILIS – International Land Information Services and HIID – The Harvard Institute for International Development. GTZ provides technical assistances on tax planning, management, auditing and assessment, payment control and enforcement, personnel training and organization. The experts from IRS provides training in tax auditing, collections and management. Funded by the World Bank, ILIS provides technical assistance in land valuation. HIID helped design the 1983-1985 tax reforms.

III. TAXATION, REDISTRIBUTION AND GROWTH

Despite progress in the implementation of the 1983-1985 tax programmes, the tax system in Indonesia remains inflexible, inefficient and less progressive. For that reason, the expenditure side of the public budget is expected to carry most of the tasks for pursuing the equity objective of the fiscal system. Improving access of the low-income groups to publicly provided basic education and health care is an important element of government programme for reducing poverty. Adequate provision of health care and education services to the low-income groups improves their productivities and capabilities to respond to economic opportunities.

The new tax system has however corrected sectoral distortions that impede domestic savings mobilization and improved efficiency in resources allocation, though the achieve-

ments in these areas also depended on the improvements in other macro- and micro-economic policies as well as on improvements in social infrastructure.

Taxation, saving and investment

Economic literature provides no clear cut answer how tax policy affects savings behavior. The literature tends to concentrate on how taxes affect the net interest or yield rates of savings instruments and the calculation of the interest elasticity of savings. Such a two-period analytical framework, however, may be ambiguous. The impact of a change in interest rates depended on a balancing of substitution and wealth effects.[4] The impact of tax policy on savings also depends on its effects on redistribution of income and marginal propensity to save. If the government's marginal propensity to save exceeds that of the private sector, the net effects of an increase in taxation with a concomitant increase in government spending is an increase in capital formation. On the other hand, savings may be reduced if the tax is mainly generated from the capitalist group whose marginal propensity to save tends to exceed that of the poor income groups.

Literature on how investment behavior responds to changes in tax policy is analysed in the neoclassical framework which concentrates on the impact of (the corporate) tax policy on the cost of capital. Tax holidays, tax credit, investment allowances and accelerated depreciation schemes may be accommodated within this cost of capital approach. Other than that, such an analysis is not readily applicable to developing countries like Indonesia. As in many countries, the corporate tax structure in Indonesia is interlaced with the personal income tax (for instance through the tax treatment of dividends and capital gains). Moreover, as most of the firms use debt finance on the margin and debt interest is deductible, the corporate tax rate leaves the cost of capital unaffected.

Indeed, Indonesia has an impressive record in economic development during the past 25 years. The rapid rate of economic growth at an annual average of over 6 per cent during this period has been possible because, annually, Indonesia invested over 20 per cent of its GDP. It is also equally impressive because the bulk of the resources required came from domestic savings. However, the debate in economic literature on the effects of tax policy on the mobilization and deployment of domestic savings may not be relevant in understanding the case of Indonesia. The financial system of the country is still in the early stage of development. Banking system is the main provider of external capital to business. Capital markets are imperfect, shallow and narrow. Transaction costs are very high, partly because of the weak and asymmetric information flow.

Until recently, the financial system was repressed. In the banking industry, the authorities adopted ceiling cum selective credit policy with artificially low interest rates. State-owned banks provided upto three quarters of the investment costs in the priority economic sectors, at negative real interest rates. Under such a repressed financial system, credit was allocated through non-price rationing mechanisms, implying that investment behaviour was constrained by quantity of bank credit. Until December 1987, the capital market was also repressed as through PT Danareksa – the state-owned trust funds – directly controlled the prices of securities traded in the Jakarta stock exchange. Prior to October 1988, the income tax was

[4] A.B. Atkitson and J.E. Stiglitz, *Lectures on Public Economics* (New York, MacGraw-Hill, 1980).

biased against investment in securities as incomes from them were taxed while bank interests were not. Deregulation in credit and interest rate policies were initiated since June 1983.

At the level of individual industries, investment behaviour can be influenced by industrial policies to nurture a particular sector, industry or firm. The investment behaviour is also influenced by the conditions of market infrastructure provided by political conditions and the accounting and legal systems. The industrial policy in Indonesia typically provides various forms of economic rents, implicit taxes and distortions other than direct-income based taxes. Notable among these instruments are the licensing system, special access to public sector procurement, trade protections, reservation schemes, export taxes and subsidies, price support systems, low prices of inputs and cheap loans, both in Rupiah as well as in foreign currencies. The latter include financial supports from the Treasury and state-owned non-bank financial institutions.

The broad-based deregulation adopted since the mid-1980s has reduced the use of these distortive instruments but has not eliminated them all. Export bans that resulted in low prices of logs and raw and semi-processed rattans, for examples, drive down the tax base in the forestry related sector. Low rate of royalties in this sector indicates low effective tax rates. Such implicit fiscal incentives have resulted in environmental degradation, inefficiency in both logging and wood-processing industries, and inhibited market diversification.

The Government controls prices of public utilities, and of some private goods which are classified as "essential" or "strategic" products. The prices are adjusted infrequently with long lags, particularly for those requiring Presidential approvals. Such direct controls have distorted prices of the affected products with adverse effects on equity, efficiency and the environment.

Tax policy and equity

As has been indicated earlier, the 1983-1985 tax reforms have been designed to promote tax neutrality and horizontal as well as vertical equity. The tax-neutrality and equity objectives are promoted through elimination of most of the sectoral distortions. The distortions are further removed by the expansion in effective tax coverage, periodic adjustment in the tax bases to prevent their erosions by inflation, simplification of tax exemptions and deductions and elimination of most of the tax incentives. The 1983-1985 tax system has removed various biases in the previous system: the biases arising from the subsidization of employment, discrimination against medium- and small-scale firms, and against long-term investment. The removal of the bias against yields of securities as opposed to interest income put the capital market at the same playing fields with the banking system. Decentralization of tax administration has also contributed to elimination of some of the biases. Along with other sound macroeconomic and sectoral policies, the improvements in fiscal neutrality have made significant contributions to domestic savings mobilization and resources allocation.

The 1983 income tax, however, has not removed all forms of tax discriminations. Profits of the cooperatives are exempted from income tax with the proviso that they are generated from activities for serving their own members. As the term "serving own members" is not clearly defined, this may have damaging effects both on efficiency and equity since designated

cooperatives are granted monopoly and monopsony powers in some commodities, particularly at the village level. For example, designated cooperatives are the only legal distributors of fertilizers and the only buyers of marketable rice surplus at the village level. Domestic trading of cloves is monopolized by the cooperatives in cooperation with BPPC – owned by a group of private traders. In West Kalimantan, by a provincial decree, only the approved cooperatives may buy citrus from farmers and sell to the designated private monopsonist.

As has also been pointed out earlier, the 1983-1985 tax system has been implemented gradually. Likewise, tax-neutrality and equity are also improved step-wise. The effective coverage and bases of the taxes as well as the degrees of tax evasion and avoidance depend on the improvements in tax administration and market infrastructure as well the progress in deregulation to remove the remaining economic distortions. The latter include quantitative restrictions on both exports and imports, exclusive access to cheap inputs and financing, and to public sector procurements including state-owned enterprises.

In Indonesia, like in other developing countries, the problems of tax evasion and avoidance are particularly severe because most of the transactions are on a cash basis. Inadequate financial records makes it difficult to check tax returns adequately. The extremely poor voluntary compliance makes the problem more difficult. The hard-to-tax groups include small businessmen, professionals and the better off farmers who actually fall within the scope of the income tax legislation. To solve the difficulty in taxing these groups, they are divided into two subgroups. Small taxpayers [turnover under Rp 60 million (US$ 30,000) and capital under Rp 10 million (US$ 5,000)] are subject to a presumptive tax and professionals are subject to tax on estimated taxable incomes. However, members of the hard-to-tax groups also include the politically powerful people. At least part of the income of these groups are simply beyond the reach of income tax collectors.

In general, the poor households are likely to pay a lower share of taxation under the 1983-1985 tax system than their shares in income. The increasing shares of taxes on income, profits, and wealth in total tax revenue following the tax reforms indicate a more progressive distribution of tax burden. Taxes levied on income and profits and wealth are almost invariably progressive and rarely affect the poor. The incidence of tax on oil and other exported natural resources partly fall on foreign consumers and alien taxpayers. Withholding taxes on labour and interest income are only paid in the formal sector, where typically workers are relatively well paid, and thus do not fall on poor households.

Taxes on domestic transactions (VAT, sales taxes, and excises) trade taxes (on exports and imports) are less regressive than before. The major VAT and excises paid by low-income households are those that affect food, energy and transport, low quality alcohol drink and tobacco consumed by them. VAT and excises on tobacco and alcoholic and non-alcoholic beverages may be regressive.

IV. CONCLUSION

After three years of preparation, Indonesia adopted major tax reforms in December 1983, covering taxes on income, value added and wealth. The reform also addressed issues relating to improvements in tax information and administration. The income tax legislation was made effective on 1 April 1984. Because it required more preparations, the implementation of

the value added tax was started on 1 April 1985, and the property tax came into effect on 1 January 1986.

The first objective of the reform has been to increase tax realization from non-oil sectors. Secondly, it was aimed to promote tax neutrality and economic efficiency by removing complicated tax incentive measures. Thirdly, it targeted to promote more effective income distribution through elimination of most of sectoral, functional and regional distortions. The fourth objective was to reduce transaction costs of transferring resources from the private sector to the public sector.

The new income tax legislation integrated the personal income tax and corporation income tax into one single income tax. The law broadens the tax base and increase the number of assessees by defining income to include any increase in economic well-being, both in monetary forms and in-kind fringe benefits. It simplifies exemptions, deductions and tax expenditure provisions. To help relieve the burden on the poor, personal exemption was substantially raised to a level much higher than annual average income per capita. With such a high personal exemption, nearly 90 per cent of Indonesia's population is exempted from income tax. Marginal tax rates are reduced to three: 35 per cent, 25 and 15 per cent. The new income tax thus brings simplicity, progressivity and certainty, and closes loopholes for tax evasion.

The type of value added tax introduced in Indonesia is a tax-credit VAT of the consumption type extending through the manufacturing-importer level. The VAT is levied at a flat rate of 10 per cent on all taxable objects whether imported or of domestic origin. This type of VAT is relatively simple as firms are allowed to credit taxes paid on all inputs including capital goods. This type of VAT, therefore, contains built-in or self-policing measures. False accounting of sales by under invoicing should be rejected by the buyers whose tax liability would be increased by such an action. With the maturation of tax administration, the taxable firms have been expanded gradually from manufacturers to wholesalers and large retailers such as Department Stores and Supermarkets.

In addition to VAT, a non-creditable special sales tax of 10 per cent, 20 and 30 per cent is imposed on specified luxury goods and products that are considered socially undesirable.

The 1986 wealth tax integrates all laws governing taxes on land and property. The new tax is levied at a flat rate of 0.5 per cent of taxable value of a property which is set between 20 and 100 per cent of its sale value. Normally, the sale value of property is adjusted once in every three years. The frequency of value adjustment, however, can be made more often, particularly in areas where property prices tend to rise markedly in a short period of time. For equity consideration, building valued up to Rp 7 million is exempted from the property tax.

The 1983 tax system has been implemented gradually. The progress of implementation of the system is determined by the maturity of the tax administration, accumulation of information on tax bases and the improvements of accounting and the legal and administrative infrastructure. To overcome the information and administrative problems, the enforcement of the 1983 income tax relies heavily on withholding mechanisms. Employers are required to

withhold tax from employees at the applicable rates. Employees are not required to file tax returns if they earn no other income. For those who has outside income, they can credit their withholding payments when filing tax returns. Institutions are obliged to withhold tax from domestic payments of interest, dividends, rents and royalties at a 15 per cent rate. Such payments made overseas are subject to a 20 per cent rate but reducible to 15 per cent rate under bilateral tax treaties. Some members of the hard-to-tax groups are beyond the reach of income tax authorities. The withholding mechanism can only tax income generated from cash transactions from legitimate businesses. Techniques, such as presumptive tax and taxes based on estimated income, can be applied to incomes generated from cash transactions.

To some extent, Indonesia has made progress in realizing the original objectives of the reform. The progress is indicated by a gradual increase of government revenue from non-oil income, VAT, and wealth taxes since the implementation of the 1983 tax reform. They all rose in absolute term as well as in proportion to GDP and total tax revenue. Thus, there is a gradual increase in tax efforts and buoyancies. The tax system became more neutral and laid the foundations for improvements in economic efficiency and distribution.

However, there is not enough information to judge the distributive effects of tax revenue. In general, oil and non-oil income taxes are almost invariably progressive and rarely affect the poor. The distributional impact of VAT and excises are unclear. They are regressive for revenues generated from alcoholic and non-alcoholic drinks and tobacco which are consumed by the poor.

The full impacts of the 1983 tax reform on government revenue, economic efficiency and equity also depended on other macro- and micro-economic policies. These include internal and external trade policy, monetary and credit policy, and wage and price policies.

The equity objectives for more equal income distribution and poverty alleviation are also pursued through the expenditure side of the public budget. In general, government expenditure has been mainly allocated for building economic infrastructure (such as dams and irrigations) and human resource programmes (such as mass education and health care programmes). Part of the infrastructure projects are aimed for employment creation for the poor. Because of the lack of information, the distribution effects of government expenditure are, however, also unclear. Patchy information indicates that, at least for some items, government expenditure is also quite regressive. The World Bank study[5] on distributional impact of education and health care programmes, for example, indicates that most of the benefits of these programmes are accrued not to the lower income groups.

[5] The World Bank, *"Indonesia-Public Expenditures, Prices and the Poor,* Resident Mission, Country Department III, East Asia and Pacific Region (1993).

PAKISTAN

I. A PROFILE OF THE TAX SYSTEM

A sharp increase in public expenditures during the 1980s was not matched by a corresponding increase in government revenue. Fiscal deficit increased to reach 8.5 per cent of GDP in 1987/88. The Government did mount some serious efforts since then to increase tax revenues.[1] As a result tax revenue share in GDP increased from 13.8 per cent in 1987/88 to 14.6 per cent in 1989/90. However, the share declined to 12.7 per cent in 1990/91 and had averaged around 13.5 per cent during 1991/92 and 1992/93.

During the period 1987/88 to 1993/94, a number of initiatives have been taken however to broaden tax coverage as well as to improve tax administration. The sales tax net has been widened and in the 1994/95 budget, sales taxes have been imposed on all the goods except food, medicine and agricultural inputs. Ad-hoc measures such as presumptive and withholding taxes as final assessment in case of exporters and contractors, and capacity taxation in case of excisable goods, were instituted to improve collection of tax revenue. At the same time, additional fiscal concessions have been granted to stimulate private investment, industrialize the backward areas and to promote "key" industries, all of which tend to reduce public revenues.

With a view to improving the efficiency of domestic production, an attempt has been made to rationalize the tariff structure. The maximum tariff has been reduced from more than 225 per cent in the mid-1980s to 70 per cent in the 1994/95 budget. Besides custom duties, import license fees and other surcharges have also been abolished. Duty structure has also been rationalized with a view to improving productivity by reducing the average and the dispersion in the effective protection rate. The tax policy measures taken in the 1980s and the 1990s have also affected the pattern of income distribution by changing the incidence of taxes.

The country's tax structure has been thus undergoing changes in the 1980s and early 1990s but considerable lacunae still exist requiring the reform process to be carried further.

Fiscal federalism

Pakistan is a federation of four provinces and the functions of both the provincial and the federal governments and their respective powers to raise revenue are defined in the constitution. Provincial governments on their own have the power to raise land revenue, registration fees on motor vehicles, property taxes, stamp duties and certain other minor taxes. They also have the power to raise agricultural income taxes but in the past they have refrained from imposing of the tax.[2] The federal government, on the other hand, is empowered to levy all

[1] These efforts have largely been made to meet the conditionalities of Structural Adjustment and Stabilisation Programs of IMF and World Bank.

[2] In the 1994/95 budget, three of the four provincial governments have introduced agricultural income tax in their finance bills.

the major taxes including the income tax, the wealth tax, customs duties, sales taxes and excise duties. The constitution also provides for the appointment of National Finance Commissions every four years to determine the share of federal and provincial governments in revenue collected by the federal government. Such a commission was first appointed in 1974 but not repeated again until 1985, and the sharing of federal tax revenue between the federal and provincial governments remained a largely unsettled issue. A Commission appointed in 1991 however rather sharply increased the share of the provinces in federal tax revenues.

The National Finance Commission Award of 1991, like the award of the previous commissions, provided for a divisible pool of tax revenues collected by the federal government. The divisible pool included the income and corporation tax, sales tax, export duty on cotton, and excise duty on tobacco, tobacco manufactures and sugar.[3] Besides, provincial governments were awarded the excise duty surcharges, and royalties on natural resources located in their areas.

The federal government accounts for the overwhelming proportion of total collection of revenues (95.7 per cent in 1990/91). Provincial governments made virtually no effort to mobilize additional resources because the federal government financed the entire deficit of provincial governments. The provincial governments have made some efforts since 1991/92 to mobilize resources but mainly from non-tax sources. The share of provincial governments in total revenue increased from 4.3 per cent in 1990/91 to 7.5 per cent in 1992/93. The share of tax revenue collected by the federal government has remained high and has further increased to account for almost 96 per cent of the total tax revenue (see table 1). Owing to the increase in non-tax revenues as well as higher share of receipts from the federal taxes, the resources of provincial government have also increased. The share of provincial governments in taxes collected by the federal government increased sharply from 27.2 per cent in 1990/91 to 37.0 and 37.3 per cent, respectively, in 1991/92 and 1992/93 (see table 2).

Despite a substantial increase in the share of provincial governments in the federal tax revenues and the increase in their own non-tax revenue, the provincial governments could barely meet their need for non-development expenditures. They had to depend on grants from the federal government for financing development expenditures. Since maintenance of physical and social infrastructures is the responsibility of the provincial governments, they were not always keen on implementing development projects proposed by the federal government because of the consequent increase in current expenditures. Since physical and social infrastructures have direct bearing on the welfare of the common man, the existing pattern of distribution of taxes between the federal and provincial governments thus ran counter to equity considerations.

Main sources of tax revenue

The share of public revenue in GDP, consisting of both tax and non-tax revenues, continued to increase during the period 1980/81 to 1985/86. Since then the revenue/GDP ratio seems to have stagnated or declined. While non-tax revenues have somewhat increased, the tax/GDP ratio has declined. Pubic revenues have stagnated while a sharp increase

[3] The 1974 Award did not include the excise duty on tobacco, tobacco manufactures and sugar in the divisible pool.

Table 1. Proportion of tax and non-tax revenues collected by the federal and the provincial governments

Period	Share of federal government			Share of provincial governments		
	Total	Tax revenue	Non-tax revenue	Total	Tax revenue	Non-tax revenue
1979/80	93.8	94.4	90.7	6.2	5.6	9.3
1980/81	93.9	94.0	93.4	6.1	6.0	6.6
1981/82	93.5	93.9	91.5	6.5	6.1	8.5
1982/83	94.4	94.8	92.4	5.2	5.2	7.6
1983/84	94.7	94.4	95.5	5.3	5.6	4.5
1984/85	94.4	94.6	95.3	5.6	5.4	4.7
1985/86	94.4	95.1	91.5	5.6	4.9	8.5
1986/87	94.4	95.2	91.1	5.6	4.8	8.9
1987/88	94.8	95.2	93.3	5.2	4.8	6.7
1988/89	95.8	95.6	96.5	4.2	4.4	3.5
1989/90	95.8	95.5	97.0	4.2	4.5	3.0
1990/91	95.7	95.9	94.5	4.3	4.1	5.5
1991/92	92.7	95.4	83.8	7.3	4.6	16.2
1992/93	92.5	95.8	83.1	7.5	4.2	16.9

Source: *Economic Survey, 1987-88* and *1993-94.*

Table 2. Share of provincial governments in taxes collected by the federal government

Period	Taxes collected by federal government (Billion Rs)	Transfers to provincial government (Billion Rs)	Percentage share of provincial governments in revenues collected by federal government
1979/80	30.7	6.1	19.7
1980/81	36.5	8.6	23.6
1981/82	40.4	9.2	22.9
1982/83	46.5	10.0	21.5
1983/84	50.6	11.3	22.3
1984/85	57.9	11.9	20.6
1985/86	68.9	12.9	18.7
1986/87	78.9	13.4	17.0
1987/88	89.0	16.2	18.2
1988/89	105.5	23.9	22.7
1989/90	114.0	30.9	27.1
1990/91	124.3	33.8	27.2
1991/92	156.6	58.0	37.0
1992/93	174.5	65.1	37.3

Source: *Economic Survey, 1987-88* and *1993-94.*

has taken place in public expenditures. As a percentage of GDP, public expenditures increased from less than 20 per cent in the early 1980s to around 26 per cent by the early 1990s (table 3). Consequently, the fiscal deficit averaged more than 8 per cent of GDP in the 1985/86 to 1992/93 period. It was imperative therefore that Pakistan examined its tax structure and formulated a long run fiscal strategy.

Table 3. Consolidated federal and provincial revenues (Percentage of GDP)

Period	*Total revenue*	*Tax revenue*	*Public expenditure*	*Fiscal deficit*[a]
1980/81	13.8	11.7	19.6	5.3
1981/82	14.5	12.0	19.6	4.5
1982/83	14.3	11.8	19.5	4.7
1983/84	17.2	13.9	23.8	6.0
1984/85	16.4	13.0	24.7	7.8
1985/86	17.5	14.1	26.1	8.1
1986/87	18.1	14.5	26.6	8.2
1987/88	17.3	13.8	26.7	8.5
1988/89	18.0	14.3	26.1	7.4
1989/90	18.6	14.6	25.9	6.5
1990/91	16.1	12.7	25.6	8.7
1991/92	18.0	13.7	26.7	7.5
1992/93	17.8	13.2	25.9	7.9

Source: *Economic Survey, 1987-88* and *1993-94*.

[a] Total revenue minus expenditure.

Pakistan's reliance on indirect taxes is not only heavy but has also been increasing over time. Indirect taxes accounted for as much as 85.8 per cent of the tax revenues in 1985/86 compared to 78.6 per cent in 1970/71 (see table 4).[4] Despite some decline in recent years, indirect taxes were as much as 79.4 per cent of the total tax revenue in 1992/93.

Direct taxes account for just one-fifth of tax revenues. This is not surprising because direct taxes generally play a minor role in the initial stages of economic development both due to problems in tax administration as well as due to low incomes and wealth of the citizens. However, the share of direct taxes is expected to increase as tax administration improves, significance of subsistence activities decline, and total income and wealth increase. In the case of Pakistan, the opposite seems to have happened and the share of direct taxes declined from 21.4 per cent in 1970/71 to 16.0 per cent in 1990/91 owing largely to exemptions granted to personal and corporate income taxpayers.[5] The share of direct taxes has increased again recently and accounted for 21.0 per cent of the total tax revenue in 1992/93. This increase can be attributed to the introduction of measures such as presumptive taxes and tax withholding.

Indirect taxes, especially customs duties, typically form a major proportion of public revenues of a developing country. However, the importance of custom duties tend to fall and

[4] Custom duties on imports and exports, Iqra surcharge, excise duties and sales taxes are the main indirect taxes. Excise duties are imposed only on the domestic production while sales taxes are levied on both the imports as well as the domestic production.

[5] Personal and corporate income taxes are the two main heads of direct taxes. Other direct taxes include estate duty, wealth tax, gift tax, stamps, land revenues, motor vehicles tax and property tax. However, except for income and corporation taxes, other direct taxes are relatively very small; the income and corporation taxes account for about 92 per cent of direct revenues.

that of taxes on domestic production, along with the share of direct taxes, increase as the economy develops. In Pakistan, however, taxes on international trade have increased more rapidly than the taxes on domestic production; the share of taxes on international trade thus went on increasing from 32.8 per cent in 1970/71 to 45 per cent in 1990/91. The taxes on domestic production on the other hand declined from 45.8 per cent in 1970/71 to 39 per cent in 1990/91. The decline in taxes on domestic production is even mor pronounced if surcharges are excluded, from 43.4 per cent in 1970/71 to only 29.6 per cent in 1992/93.

Indirect taxes, such as excise duties, sales taxes and custom duties are generally imposed on manufactured goods. Since the manufacturing sector has grown the fastest, on average at a rate of 1.5 times the growth of GDP, one would have expected the tax elasticity with respect to GDP to exceed unity. However, the elasticity and buoyancy of excise revenues have been well below unity. The elasticity and buoyancy values of total tax revenue with respect to GDP have also been less than one (table 5).

Table 4. Composition of consolidated tax revenues (In percentage)

Tax heads	*1970/71*	*1975/76*	*1980/81*	*1985/86*	*1990/91*	*1991/92*	*1992/93*
Direct taxes	**21.4**	**17.8**	**20.1**	**14.2**	**16.0**	**18.2**	**21.0**
Income taxes	16.2	13.8	18.1	13.2	14.7	17.0	19.5
Indirect taxes	**78.6**	**82.2**	**79.9**	**85.8**	**84.0**	**81.8**	**79.0**
Excise duties	36.8	28.8	27.0	21.6	19.3	18.7	19.8
Sales taxes	10.8	7.7	7.4	6.8	13.0	12.7	13.1
Import duties	24.1	28.0	34.9	39.1	35.8	37.7	35.1
Export duties	0	4.7	1.8	1.4	3.2	0	0
Surcharges	2.4	6.3	4.4	12.9	9.5	9.0	7.3
Taxes on international trade	**32.8**	**38.9**	**43.3**	**45.4**	**45.0**	**44.2**	**42.1**
Taxes on domestic production	**45.8**	**43.2**	**36.7**	**40.4**	**39.0**	**37.6**	**36.9**

Sources: A.R. Kemal, *Fiscal System of Pakistan,* a study prepared for the World Bank (Washighton, DC, 1987); and *Economic Survey, 1993-94.*

Table 5. Buoyancy and elasticity of taxes in Pakistan

Tax	*Base*	*Buoyancy*	*Elasticity*
Total taxes	GDP	0.96	0.30
Total taxes	Non-agricultural GDP	0.92	0.28
Direct taxes	GDP	1.02	0.61
Direct taxes	Non-agricultural GDP	0.97	0.58
Custom duties	GDP	1.01	0.31
Custom duties	Imports	1.01	0.31
Sales taxes[a]	GDP	1.35	–0.09
Excise duties	GDP	0.68	–0.04
Excise duties	Munufacturing	0.64	–0.03

[a] Sales taxes were also regressed against manufacturing and imports but import coefficient for buoyancy and elasticity turned out negative.

II. EXPERIENCE IN TAX REFORMS

A characteristic feature of Pakistan's tax system is the rather high rates of taxes and relatively low tax revenues. This reflected the narrow tax bases which was further eroded due to tax exemptions and concessions. Exemptions are granted in all the taxes including income and corporate taxes, the wealth tax, import duties, sales taxes and excise duties. These exemptions are also conduits for tax avoidance and evasion. Rationalization of the tax structure involving lower tax rates and withdrawal of tax exemptions was therefore expected to help in the mobilization of resources as well as in developing an efficient and equitable production and distribution structure in the economy.

The measures that have been taken by the Government to reform the four major taxes, namely, the personal and corporate income tax, excise duties, sales taxes, and custom duties are discussed below.

Direct taxes

Personal and corporate income taxes

Personal and corporate income taxes contribute most of the revenues from direct taxes. The relatively low show share of direct taxes in total revenue and as a percentage of GDP with tendencies for these shares to decline over time could be attributed largely to exemptions, full or partial, to different types of incomes. Exemptions are granted on the basis of different arguments having doubtful validity. For example, with a view to promoting savings, the Government has exempted incomes from the government savings schemes. These schemes however left the saving rate virtually unchanged but the Government lost considerable tax revenues. Both the agricultural incomes as well as agricultural assets were exempt from taxation until recently. The agricultural income tax can be introduced only by the provincial governments. Three provincial governments have decided to impose tax on agricultural incomes in the year 1994/95 but the Punjab province with more than 60 per cent of the agriculture output has not done so. Besides, it would be a presumptive tax with very little tax burden on the rich landlords.

Since 1985/86, Pakistan brought about substantial changes in the personal income tax rates. The maximum tax rate was brought down from 60 to 45 per cent in 1985/86. Tax amnesty was also announced and "whiteners'" bonds[6] were issued to those who declared their concealed incomes. Since the self-assessment scheme and the immunity provisions were retained, the income tax revenues fell after a reduction in tax rates. In 1987/88, attempts were made to get hold of the tax evaders by reducing the tax rates for those earning less than Rs 100,000 to 10 per cent on the basis of self-assessment to release income tax officials to pursue cases of higher incomes.

Further important initiatives were taken in 1990/91 to income tax reform. The maximum rate of tax was brought down to 35 per cent and at the same time certain exemptions and allowances were withdrawn. The allowances withdrawn included life insurance premia, contribution to provident funds, investment in Defence Savings Certificates and National

[6] These bonds with a face value of Rs 100 could be purchased by the tax evaders at a price of Rs 90. The bonds could be encashed at face value after three years.

Investment Trust Certificates, purchase of books, investment in the share capital of holding and industrial companies, for retirement annuity contracts and trust companies, contributions to benevolent fund and group insurance, and donations. Subsequently, however, donations with maximum limits were reinstituted.

Pakistan has been in effect using a schedular tax approach whereby dividend income, interest income, prize money etc., have been taxed at different rates. Dividends, interest, prize bond winnings etc., which were exempt from personal income taxes until the mid-1980s, were subjected to a flat rate tax of 7.5 per cent until 1990/91 and since then are taxed at a rate of 10 per cent. Withholding taxes at rates ranging between 3 to 5 per cent of the gross transactions in case of exporters, contractors, etc. are treated as the final settlement. Small businessmen are subjected to tax at a flat rate using electricity consumption as a criterion to determine status. Companies resident in Pakistan are obliged to pay a minimum tax of 0.5 per cent on its turn-over, regardless of whether any tax would be otherwise payable. These measures have served to increase revenue collections in recent years.

The corporate tax rates in Pakistan have been too high and a disincentive for companies to be forthcoming with honest tax returns. Income tax, surcharges, etc., assessed on corporate incomes could reach 66 per cent for banking companies, 44 per cent for public limited companies and 55 per cent for other companies. The Government announced a package of reforms in 1992/93, whereby taxes on banking companies were to be reduced to 55 per cent, for public companies to 30 per cent, and for other companies to 40 per cent by 1997/98. In the 1993/94 budget, Government announced further that by 1998/99, the rates of corporate income tax on banks would be reduced to 50 per cent and on other companies to 35 per cent. For the year 1994/95, the rates on three types of companies were fixed at 62, 39 and 49 per cent, respectively.

Apart from exemptions and concessions, poor tax administration that eroded the revenue potential of income taxes, was responsible for low tax realization. This was reflected in the growing significance of withholding taxes which accounted for as much as 63.3 per cent of total income tax revenues in 1991/92 (see table 6).

Table 6. Income tax revenues
(Billion Rs)

	Withholding tax payments	*Gross income tax revenues*	*Withholding taxes as a percentage of gross income tax revenues*
1987/88	5.4	13.1	41.5
1988/89	6.2	14.9	41.7
1989/90	8.0	17.8	64.5
1990/91	10.2	21.8	46.7
1991/92	18.7	29.9	63.3

Source: The Central Board of Revenue (1992).

Tax evasion, a reflection of poor tax administration, take two forms. First, persons earning more than taxable income simply do not file the tax return; actual taxpayers are no more than half the number of potential taxpayers. Second, taxes are evaded/avoided by under-reporting incomes, by suppression of transactions, under-statement of sales, over-statement of purchases and expenses, under-invoicing of exports and imports, inflating figures of bad debts, etc. The National Taxation Reforms Commission (1986) estimated that only 27.6 per cent of taxable income was assessed and if tax evasion were checked, income tax collection would increase to Rs 75 billion compared with about Rs 30 billion gross collections in 1991/92. Tax evasion can only be checked through improvement in tax administration, which calls for effective checks on the conduct of officials in the income tax department and on their discretionary powers. There is a need to develop a data base for the assessment of incomes. One may use sales/turnover, input-output ratios, profit norms, etc., to ascertain taxable income.

Indirect taxes

Import duties

Import duties are the most important source of tax revenue, accounting for more than one third of the total tax revenue. Their share had increased sharply in the 1970s and the 1980s but declined relatively in recent years. Yet their contribution to total tax revenue was as high as 33.9 per cent in 1992/93.

Until recently tariffs played very little role in the protection of the industrial sector because of the quantitative restrictions on imports. Tariffs were used essentially to generate revenue. However, efforts to raise revenue through tariffs were hampered by two major factors. First, to promote specific manufacturing industries the Government allowed them to acquire raw materials, intermediate goods and components at zero or concessional rates of import duties. The facilities were misused and the Government lost potential revenue. Second, high rates of import duties have encouraged smuggling of consumer durables and other consumption goods, thus depriving the government of revenues.

Pakistan initiated tariff reforms, along with reforms of the trade regime, in 1983/84. A series of reductions have been made in the tariff rates, but even then the average statutory import duty rate was 58.2 per cent in 1992/93. The average effective duty rate i.e., total duty as a percentage of total imports, however, has been far lower. The differential in statutory and actual rates of import duties arises from the exemptions, partial or total, to industrial users, public sector agencies, producers who have agreed to implement indigenization programmes, less developed regions, priority industries, etc. The duty-free imports accounted for 41 per cent of total imports in Pakistan in 1992/93; it was as high 48 per cent in 1990/91 (see table 7).

Thus high rates of tariffs do not necessarily generate more revenue since many users are allowed to import at concessional or even at zero rates of duty. The smuggling that it encourages further erodes duty realization. Rough estimates indicate that the value of smuggling annually amounts to Rs 100 billion with a Rs 50 billion loss of revenues assuming a 50 per cent duty rate. The goods smuggled are mostly high value consumer products such as silk and synthetic fabrics, fashion clothes, wearing apparel, electric appliances, consumer

Table 7. Duty-free imports and derived rate of import duty

Period	Total	Consumer goods	Raw materials for		Capital goods
			Consumer goods	Capital goods	
Share of duty-free imports					
1987/88	39	41	44	18	40
1988/89	38	60	36	21	40
1989/90	40	55	38	37	34
1990/91	48	57	49	17	49
1991/92	45	50	37	20	57
1992/93	41	41	26	13	57
Average rate of import duty (Including duty-free imports)					
1987/88	25	33	23	37	23
1988/89	22	19	20	33	25
1989/90	23	19	22	36	25
1990/91	20	20	16	34	20
1991/92	18	19	19	31	14
1992/93	21	24	26	39	14
Average rate of import duty (Excluding duty-free imports)					
1987/88	42	56	41	45	38
1988/89	36	47	31	41	38
1989/90	39	42	36	43	40
1990/91	39	38	39	41	39
1991/92	33	37	30	41	39
1992/93	35	41	35	45	32

Source: The Central Board of Revenue.

durables, crockeries, cosmetics and perfumes, watches and clocks, etc. Rates of import duties on these products are usually high to curb consumption and to make the incidence of taxes progressive. Smuggling, however, has effectively prevented the realization the objectives.

Sales taxes

The Sales Tax Act of 1990 prescribes a VAT-type system in which the value-added at each stage of processing and trading activity is to be taxed. However, because the tax is not collected at the sales-point (sales taxes are collected only at the import and local manufacturing stages), the value-added at the wholesale and retail-trade stages is not subject to the sales tax. A few half-hearted attempts were made to extend the sales tax to the trade stage in the last few years, but the proposals were withdrawn following protests from the trading community.

Sales taxes in the present form are nothing but a device to jack up the rate of import duty and the excise duty. Nevertheless, sales taxes assume special significance in the context of social sector development because they form a major part of the divisible pool to be shared

with the provinces. Higher proceeds of sales taxes would place larger resources at the disposal of provincial governments and thus enable them to allocate large resources to the social sector development for which they are largely responsible.

Sales taxes are imposed on both imports as well as domestic production at a standard rate of 15 per cent.[7] However, a large number of products are exempt from the payment of sales taxes, which include, among others, live animals, meat, fish, dairy products, tea, cereals, plants, drugs and medicines, books, newspapers and journals, fertilizers, insecticides, and pesticides. As a result, the average rate of sales tax on imports and domestic output in 1991/92 was 5.6 and 5.0 per cent respectively, even though the standard rate of sales tax was 12.5 per cent.

Sales tax revenue grew very slowly upto 1985/86; it barely kept pace with the growth of GDP. During the 1979/80 to 1985/86 period, it fluctuated around 1 per cent of GDP. However, over the 1986-1989 period, it grew very sharply at an average rate of 44.2 per cent essentially due to the broadened coverage of domestically produced goods. The growth of revenues slowed down in the next two years both because the tax base was not further widened and because the growth of manufacturing output had slowed down considerably. The imposition of the sales tax on additional products in 1991/92 and 1992/93 once again accelerated growth of revenues at rates of 23.1 and 13.5 per cent in 1991/92 and 1992/93 respectively (see table 8). Consequently, the share of sales tax in total tax revenues increased from 7.6 to 13.1 per cent, in federal tax receipts from 8.1 to 13.7 per cent, in the indirect tax revenues from 9.1 to 16.6 per cent, and, as a percentage of the GDP, from 0.99 to 1.74 per cent over the 1984/85 to 1992/93 period.

Table 8. Trends in sales tax revenues

Period	*Revenues (Billion rupees)*	*Growth rate*	*Percentage share in*			*Sales tax revenues as a percentage of GDP*
			Indirect taxes receipts	*Total tax receipts*	*Federal tax receipts*	
1979/80	2.4	20.0	8.9	7.4	7.9	0.95
1980/81	2.9	12.4	9.2	7.4	7.9	1.04
1981/82	3.3	7.3	9.5	7.6	8.1	0.93
1982/83	3.5	32.5	8.8	7.1	7.5	0.96
1983/84	4.6	11.8	10.4	8.6	9.1	1.10
1984/85	4.7	–	9.1	7.6	8.1	0.99
1985/86	4.9	5.6	7.9	6.8	7.2	0.96
1986/87	6.4	36.3	8.9	8.1	8.9	1.11
1987/88	8.7	35.9	10.8	9.4	9.8	1.29
1988/89	14.7	68.2	15.4	13.3	13.9	1.91
1989/90	15.6	6.0	15.0	13.0	13.7	1.82
1990/91	16.9	8.5	15.5	13.0	13.6	1.66
1991/92	20.8	23.1	15.5	12.7	13.3	1.73
1992/93	23.6	13.5	16.6	13.1	13.7	1.74

Source: Economic Survey, 1993-94.

[7] Until June 1993, the standard sales tax rate was 12.5 per cent.

The sharp increase in revenue from the sales tax owes to taxes on domestic production. The sales tax receipts from domestic production as a proportion of total sales tax receipts increased from just 20 per cent in 1984/85 to 53.1 per cent in 1992/93.

Until 1993/94, 486 products were subject to sales tax but a very large number of products were exempt. In the 1994/95 budget, the Government introduced sales tax on additional 169 domestically produced goods and 108 imported products. The only products which are still exempt from sales tax are food products, petroleum, medicines and agricultural inputs.

The wide coverage of the sales tax brings it closer to the value added tax introduced in many other countries. A shift of the collection mechanism of sales taxes from the production and import stages to the sales-point would yield three distinct advantages. First, the mechanism would allow collection of sales taxes from even the smuggled goods. Second, value-added in the trading activity will also become taxable. Since value-added at the wholesale and retail trade stages is around 20 per cent, tax revenue would increase by 20 per cent even if the base and the rate of sales tax remain the same. Third, it will force traders to keep a record of the sales and purchases which, in turn, would facilitate the effective collection of both sales and income taxes.

Excise duty

A very limited number of products are subject to excise duties. Excise duties are generally imposed to curb conspicuous consumption, to influence the production patterns, and to correct for the externalities in both the production and the consumption patterns. But excise duties in Pakistan are essentially a tax on the domestic production of goods and services and seems to have been imposed just to generate additional revenues.[8]

The revenue from excise duties has increased relatively slowly. It stagnated during 1983/84 to 1986/87, and increased at a rate of 15.1 per cent in the 1986/87 to 1992/93 period (see table 9). The stagnant revenues in the 1984/85 to 1986/87 period and relatively slower growth of excise duty led to a decline in the excise tax revenue as a percentage of total tax revenue from 32.2 to 19.8 per cent and as a proportion of indirect revenues from 38.8 to 25.1 per cent over the 1979/80 to 1992/93 period.

The slow growth of the excise tax revenues may be attributed to three main factors. First, the industries subject to excise taxes have grown at a relatively slow rate. Compared to the average industrial growth rate of 6.3 per cent, the industries subject to excise duties have grown at a rate of 5.5 per cent. Second, very few additional products have been subjected to excise duties. Third, out of the 39 products on which excise duties are levied as many as 18 are subject to specific duty rates and, revenue from specific duty rates typically increases less rapidly. In the 1994/95 budget, however, the specific excise duty rates have been turned into ad valorem rates.

In view of the administrative problems in the collection of excise duties, a system of capacity taxation was introduced on a number of products including sugar, cement, soda ash,

[8] The excise duty on tobacco products seems to be the only exception where, presumably, it has been imposed to curb consumption.

Table 9. Revenues realized from central excise duty

Period	Revenues (Billion rupees)	Growth rate	Revenue from excise duty as a percentage share in		
			Total taxes	Indirect taxes	GDP
1979/80	10.5	-	32.2	38.8	4.2
1980/81	12.2	16.5	31.4	39.0	4.3
1981/82	13.6	11.4	31.7	39.9	4.2
1982/83	15.6	14.5	31.8	39.2	4.3
1983/84	15.7	1.0	29.4	35.4	3.8
1984/85	15.4	-0.2	27.6	33.4	3.1
1985/86	15.6	1.1	21.6	25.1	3.0
1986/87	15.5	-0.6	18.7	21.6	2.7
1987/88	17.4	13.0	18.6	21.5	2.6
1988/89	20.0	14.9	18.1	20.9	2.6
1989/90	23.1	15.5	19.3	22.3	2.7
1990/91	24.7	6.9	19.1	22.7	2.4
1991/92	30.3	22.7	18.7	22.9	2.5
1992/93	35.2	16.0	19.8	25.1	2.6

Source: *Economic Survey, 1986-87* and *1992-94.*

vegetable ghee, cotton fabrics, and cotton yarn during 1990/91. The production capacity of a plant was fixed in this system by the Central Board of Revenue.[9] As such it involved no assessment of actual production or the supervision of production and clearances by tax authorities. The system provided an incentive to production because the output in excess of the notified capacity of a factory was exempt from duty. There are, however, problems in determining the capacity of an industrial unit. These considerations have led to its withdrawal recently. Cement and beverage industries were taken off the capacity list in the 1993/94 and all other products subject to capacity taxation has been removed in the 1994/95 budget.

III. TAXATION, GROWTH AND EQUITY

Taxation and resource allocation

Whereas import tariffs on end products protects domestic industries, tariffs on inputs and excise duties on domestically produced goods tend to lower the protection rate. To promote domestic industries, the Government has allowed certain industries to import inputs duty-free and in certain cases on concessional terms. Industries have also been provided with fiscal incentives including tax holidays, tax credits and accelerated depreciation. These concessions, along with distortions in the tariff structure, has resulted in high effective protection rates (EPR) as well as domestic resource cost (DRCs).

The tariff and non-tariff restrictions on imports, taxes and subsidies on exports and on domestic production, and the effectiveness with which these are implemented, determine the

[9] The rules also provide for abatement of duty on account of shut-down of factory or shortfall in its production for reasons beyond the control of the manufacturers.

actual level of protection enjoyed by an economic activity. Such protection results in higher returns to production factors employed in the protected activities which, in turn, results in a reallocation of resources towards the protected activities. The relevant variable from an industry's stand point is the effective protection rate, which is the estimated percentage increase in the value-added due to protection. The nominal protection rate, which is reflected in the change in the domestic price of a product due to protection, on the other hand, determines the extent to which consumer's surplus is affected by the tax structure.

Since fiscal incentives in the form of lower import duties on raw materials and capital goods and in the form of tax holidays, accelerated depreciation allowances, tax credit etc. also influence the profitability of the firms, these are discussed before presenting the estimates of EPR.

Tax exemptions to industrial activities

Import duty rates expressed as a percentage of total imports compared to the statutory rates, have been lower due to various exemptions and concessions to importers. The exemptions have been granted to realize various objectives, which include the following:

(a) Promotion of specific industries: Specific industries have been allowed to import their raw materials and requirements of intermediate goods at reduced duty rates or without payment of any duty.

(b) Stimulation of investment in specific areas: The investors in various industrial estates, backward areas, and the rural areas have been allowed to import machinery and equipment at reduced or zero rate of import duty.

(c) Transfer of technology: With a view to encouraging the setting up of assembly plants in the first stage and progressive manufacturing of components at a later stage, the producers have been allowed to import components at reduced rates.

(d) Concessions to privileged persons and organization: Imports by diplomats, United Nations organizations, and Pakistani senior officials including the president, the governors, the chiefs of staff, etc., are allowed at concessional or zero duties.

(e) Exemptions to hospitals and similar institutions: Hospitals are allowed to import equipment and machinery without payment of any duty. Similarly, different educational institutions are provided such a facility.

(f) Conditional exemptions: These are granted to various industries fulfilling certain conditions.

(g) Export processing zones: Industries located in the zone are allowed to import machinery and raw materials without payment of duty.

(h) Baggage allowances: The incoming passengers are allowed to import or buy from duty-free shops goods upto a specified limit without payment of duty, and some additional goods after the payment of concessional duties.

These concessions have been grossly misused. Total imports of goods covered by these concessions amounted to Rs 52 billion in 1992/93, out of which goods worth Rs 33 billion

were imported duty-free. Since these estimates do not incorporate imports at reduced rates of duty, the total amount of concessional imports may be even higher. Only 14 per cent effective duty was collected on these products, which would have been 50.5 per cent if there were no duty-free imports. More than two thirds of total imports of a large number of products enter the market duty-free (see table 10). Revenue from these products are even less than 10 per cent of the total value of their imports.

Besides tariff concession, the Government also provides income tax reliefs and exemptions to industrial units with a view to stimulating private investment, promoting certain industries and developing specific areas. Tax holiday for three years are available to all manufacturing units in Pakistan irrespective of their location, a 5 year tax holiday to units located in the industrial estates or in the less developed areas, an 8 year tax holiday to the units located in rural areas, and a 5 year tax holiday to the "key" industries. Tax relief is also provided through tax credits and accelerated depreciation allowances.

Fiscal incentives to stimulate investment are redundant because protection ensures rather high profits even in the absence of these incentives. Fiscal incentives have not played any role in promoting the priority sectors or developing the backward areas because fiscal incentives at best only leave profitability at the pre-tax levels. Tax holidays have been effective in reallocating the resources only towards fringes of the developed regions, which have deprived the government of revenues, on the one hand, and have resulted in gross inefficiencies in production, on the other. The loss of revenues due to these fiscal incentives amount to Rs 10 billion annually.[10]

Effective protection rates and DRCs

Four main factors determining the effective protection rate for an economic activity are: the nominal protection rate on competitive imports; taxes on the output of the domestic activity; nominal protection on inputs used in the activity; and the value-added coefficient defined as a ratio of the value-added to gross output. It is obvious that higher the nominal protection to output and the lower the taxes on domestic production, the nominal protection to inputs and the value-added coefficient, the higher will be the effective protection rate (EPR). It may also be noted that if the nominal protection rate on output and the inputs is the same, the EPR is equal to the NPR, irrespective of the value-added coefficient.

Tariffs in Pakistan have been redundant in protecting three fourths of the industries and as such the explicit effective protection rate (EPR)[11] is not the relevant measure of protection. Because of the smuggling and the industries which have graduated from import substitution to export orientation industries, it is more relevant to use the implicit effective protection rate (IEPR). The IEPRs makes use of the actual differentials in the domestic and the world market prices of inputs and outputs, and correctly measures the protection enjoyed by an economic activity.

[10] A.R. Kemal, Zafar Mahmood and Ather Maqsood Ahmed, *Structure of Protection, Efficiency, and Profitability*, a study submitted to the Resource Mobilisation and Tax Reforms Commission (in 4 volumes) (Islamabad, Pakistan Institute of Development Studies, 1994).

[11] The EEPRs are computed by assuming that the differential in the domestic and the world market prices is equal to import duties.

Table 10. Concessionary imports under different SROs

SRO	*Description*	*Total imports*	*Duty-free imports*	*Proportion*	*Revenue collected*	*Effective rate*
349(1)/85	Raw and packing material used in the manufacture of the pharmaceutical product	2 701 317.47	2 646 424.34	0.98	17 965.60	0.01
457(1)/88	Raw material for syringes and infusion sets	543 851.31	123 886.92	0.23	228 876.87	0.42
460(1)/88	Components and raw material for the local manufacture of two- or three-wheelers	154 480.75	37 645.53	0.24	72 498.00	0.47
467(1)/88	Steel wire imported for the manufacture of tyres	71 690.46	48 807.54	0.68	16 318.09	0.23
495(1)/84	Components for the local manufacture of vehicles	509 556.21	164 799.84	0.32	181 444.83	0.36
498(1)/84	Components and raw material for the manufacture of bicycle parts	154 480.75	37 645.53	0.24	72 498.00	0.47
502(1)/88	Parts and components for the manufacture of scientific and medical instruments	11 460 686.39	5 431 037.73	0.47	2 506 474.68	0.22
509(1)/89	Raw material imported for the local manufacture of printing ink	1 636 341.19	28 791.98	0.02	787 282.34	0.48
510(1)/88	Raw material for the formulation of pesticides	86 008.96	49 220.32	0.57	13 570.12	0.16
520(1)/90	Raw material imported for the manufacture of dairy	69 038.12	10 252.07	0.15	30 441.56	0.44
540(1)/90		386 063.21	90 448.44	0.23	145 223.50	0.38
558(1)/90	Raw material and components imported for textile machine-parts and accessories	14 648 277.80	13 286 033.89	0.91	241 818.56	0.02
560(1)/90	Raw material and components imported for boilers and generators	2 868 771.26	2 300 801.00	0.80	186 270.99	0.06
587(1)/90	Raw material imported for the manufacture of basic pharma-active ingredient	2 701 317.47	2 646 424.34	0.98	17 965.60	0.01
600(1)/83	Components of raw material for the manufacture of capital goods and machinery	8 729 311.88	4 264 904.41	0.49	1 256 580.72	0.14
601(1)/83	Raw material for the manufacture of wires and cables, bolts, nuts, and machines screw, tubing for transformers, wires, ropes, welding electrodes, aluminum rods, etc.	4 847 676.72	1 464 771.33	0.30	1 498 762.49	0.31
602(1)/83	Delivery of raw material without payment of customs duty and sales tax	108 872.24	86 178.67	0.79	13 622.35	0.13
1195(1)/88	Exemption of customs duty and sales tax on raw material imported for tyres and tubes	377 091.18	261 985.86	0.69	21 895.36	0.06
Total		52 054 833.37	32 980 059.74	0.63	7 309 509.66	0.14

Source: A.R. Kemal, Zafar Mahmood and Ather Maqsood Ahmed, *Structure of Protection, Efficiency, and Profitability*, a study submitted to the Resource Mobilisation and Tax Reforms Commission, in 4 volumes (Islamabad, Pakistan Institute of Development Economics, 1994).

The average effective protection rate in 1990/91 came to be 77 per cent, which was 11 per cent higher than the earlier estimate of effective protection rate in 1980/81 made by the present author. It is interesting to note that the effective protection rate increased in the period when tariffs were being rationalized. The seemingly perverse result may have been due to two main factors. First, the fiscal anomalies which had yielded negative effective protection to a number of industries in 1980/81 were removed so that only a couple of industries had a negative effective protection rate in 1990/91. The fewer negative rates pushed up the average effective rate. Second, the tariff rationalization process had hardly any impact on the nominal protection rate on output, but had sharply reduced import duties on inputs which tended to increase the effective protection rate.

The average protection rate conceals rather sharp variations in the EPRs across different industries; the EPRs range between the negatively protected industries and the negative value-added industries. The sharp variations in the EPRs are well-reflected in the estimated standard deviation of 71 and the coefficient of variation of 163. It may be noted that it is the dispersion in the EPRs rather than the average EPR which determines the relative allocative efficiency of the resources employed in the manufacturing sector. The magnitude of the effective protection rate determines the technical and x-efficiency of an activity.

The cost of protection may be defined as (i) the wasteful use of domestic resources in the activity of earning (saving) foreign exchange; or as (ii) the difference between the share of the manufacturing sector in the GDP at world market prices and that at domestic market prices. The first definition corresponds to the notion of economic waste that a protectionist regime entails, while the second definition focuses on the implicit transfer of domestic resources from the rest of the economy to the protected sectors.

The first estimate of the economic waste relates to the domestic resources employed in the protected sector in excess of its real contribution to GDP, i.e., value-added at the world market prices. The estimated average DRC in Pakistan's manufacturing sector is 1.44, indicating that the value of domestic resources used up are 44 per cent higher than the real contribution of the manufacturing sector to GDP. The cost of protection may also be estimated alternatively as the difference of a sector's contribution to the GDP at the world and the domestic market prices. What these measures indicate are the degree of inefficiencies protected and the resultant loss of output to the economy while artificially propping up private profits.

Poverty and equity

Measures of inequality and poverty

Poverty and income distribution seem to have worsened in Pakistan in the latter part of the 1980s. A deterioration in the personal income distribution is indicated by changes in functional income distribution (table 11). The share of wages in national income fell from 32.3 per cent in 1987/88 to 30.0 per cent in 1990/91 which had implications for personal income distribution. Personal income distribution had improved in the 1978/79 to 1987/88 period, but worsened considerably in the 1987/88 to 1990/91 period. The Gini coefficient increased from 0.35 in 1987/88 to 0.41 in 1990/91. The share of income received by the lowest 20 per cent and the highest 20 per cent of households also suggest improve-

ment in income distribution upto 1987/88 but a sharp deterioration in the subsequent period (see table 12).

The increase in income inequality in the rural areas has been more pronounced; the Gini coefficient for the rural areas rose from 0.307 to 0.410 compared to an increase from .366 to .390 in the urban areas over the period 1987/88 to 1990/91. The income inequalities in rural areas may have increased due to the elimination of subsidies on agricultural inputs. Removal of subsidies tended to lower the incomes of both the poor and the rich, but the increase in output prices compensated the bigger landlords for the increased input prices. The poor were compensated far less, if at all.

Table 11. Functional income distribution (Percentage share)

Period	*Wage share in national income*
1980/81	30.2
1981/82	30.2
1982/83	30.1
1983/84	30.7
1984/85	30.1
1985/86	31.8
1986/87	33.0
1987/88	32.3
1988/89	30.0
1989/90	30.2
1990/91	30.0

Source: M. Khairat Chaudhary, *Report of the Sub-committee of the Committee on Economic and Social Well-being for the Eighth Five Year Plan on Personal, Functional and Regional Income Distribution* (Islamabad, Pakistan Institute of Development Economics, 1993).

Table 12. Income distribution in Pakistan

Period	*Gini coefficient*			*Household income share*	
	Total	*Rural*	*Urban*	*Lowest (20 per cent)*	*Highest (20 per cent)*
1963/64	0.355	0.348	0.368	6.4	45.3
1966/67	0.351	0.314	0.388	7.6	43.4
1968/69	0.328	0.293	0.370	8.2	42.0
1969/70	0.330	0.295	0.361	8.0	41.8
1970/71	0.326	0.273	0.359	8.4	41.5
1971/72	0.344	0.309	0.381	7.9	43.0
1979	0.375	0.319	0.380	7.4	45.0
1984/85	0.428	0.345	0.379	7.3	45.0
1985/86	0.355	0.330	0.354	7.6	44.0
1986/87	0.346	0.312	0.357	7.9	43.6
1987/88	0.348	0.307	0.366	8.0	43.7
1990/91	0.407	0.410	0.390	7.3	44.5

Sources: Federal Bureau of Statistics; and State Bank of Pakistan, *Annual Report: 1992-93* (Karachi, 1993).

Absolute poverty in terms of the head count ratio has also increased during the 1987/88 to 1990/91 period after a sharp decline during 1984/85 to 1987/88.

Table 13. Trends in poverty in Pakistan

Provinces	*Percentage of population below poverty line*		
	1984/85	*1987/88*	*1990/91*
Pakistan			
Overall	20	13	14
Rural	22	14	16
Urban	16	10	11

Source: Federal Bureau of Statistics.

Incidence of taxes

Studies on tax incidence in Pakistan are rare. The few studies that have been undertaken differ in the time periods covered, the coverage of taxes and the methodological framework employed to assess tax incidence. Irfan estimated the incidence of excise taxes on only tobacco and petroleum products in 1971/72. Alauddin and Naqvi[12] considered incidence of all the taxes except import duties for the year 1971/72. Both the studies computed the incidence of taxes on the basis of nominal tax rates rather than tax collection.[13] On the other hand Jeetun, Qureshi, and Malik and Sagib examine the incidence of all the federal taxes on the basis of actual tax collections rather than nominal rates. Jeetun's study relates to the year 1972/73, Malik's to the year 1978/79 and Qureshi's to the year 1984/85. The incidence of indirect taxes has been estimated on the basis of consumption pattern derived from the Household Income and Expenditure Surveys.[14]

In the present exercise, attempts have been made to estimate the incidence of income taxes, excise duties, custom duties and sales taxes for the years 1987/88 to 1990/91 on the basis of consumption data obtained from Household Income and Expenditure Survey of the year 1987/88. Unpublished disaggregated tax data obtained from the Central Board of Revenue have been used.

[12] Mohammad Irfan, "Shifting and incidence of indirect taxes on tobacco and petroleum products in Pakistan", *Pakistan Development Review* (Spring, 1974); Talat Alauddin and Bilguees Naqvi, *Tax Progressivity in Pakistan*, Research Report No. 123 (Islamabad, Pakistan Institute of Development Economics, 1981); Azad Jeetun, *Incidence of Taxes in Pakistan*, Discussion Paper No. 2 (Karachi, Applied Economic Research Centre, University of Karachi, 1978); M.L. Qureshi, *Incidence of Federal and Provincial Taxes and Appraisal of Economic and Distributive Effects of Direct Taxes*, a study prepared for National Taxation Reforms Commission (Lahore, Development Studies Institute, 1988); and M.H. Malik and Najam-us-Sagib, "Tax incidence by income classes in Pakistan, *Pakistan Development Review* (Winter, 1989).

[13] Tax collections reflect better the total tax burden as there are various exemptions, and statutory rates are not enforced in a number of cases. For example, compared to an average statutory rate of import duty of 59.8 per cent, the rate of import duty on the basis of revenues collected in 1989/90 comes out to be 28.8 per cent. See Kemal (1991) for the impact of exemptions on the tax rates. However, if the tax exemptions are specific to particular classes, the use of realized revenues may also bias the result.

[14] Jeetun's study is based on 1971/72 Survey, and Malik's and Qureshi's on the 1979 Survey.

The estimation of tax incidence poses two problems. First, commodity classification used in the Household Income and Expenditure Survey and by Tax Authorities is not the same. This problem is not severe and was overcome through reclassification. Second, intermediate and capital goods account for a large proportion of taxes collected and as such these had to be apportioned to various consumption goods for assessing their incidence on various sections of the society. This problem can be overcome either by using the input-output table or by making educated guesses as to where the intermediate and capital goods will be used. No input-output table for a recent year[15] is available and therefore the input-output table of 1975/76 as well as that in Qureshi and Jeetun's studies to apportion the taxes to various activities have been used. The results are reported in tables 14-19.

The results presented in table 11 to 16 show that Pakistan's tax structure is slightly progressive but it is almost proportional below the top income slab. This is in line with the results obtained in the earlier studies and the results hold for all the four years. Nevertheless, it is rather important to note that while the tax incidence has increased most for the lowest income group, the incremental burden goes on falling as incomes rise and for the highest income group, tax incidence, in fact, has declined over the 1987/88 to 1991/92 period (see table 20). Compared to a decline of 4.3 per cent in the tax burden for the richest section of the population, the tax burden on the lowest income class has increased by 10.3 per cent. This pattern of the increase in tax burden is essentially a reflection of the emphasis on additional indirect tax mobilization, particularly the sales taxes. The increase in sales taxes has essentially come from those products which form relatively higher proportion in the poor's consumption bundle.

Table 14. Incidence of excise duties

Income groups (Rs per month)	*Tax paid/income*			
	1987/88	*1988/89*	*1989/90*	*1990/91*
Upto 600	3.33	3.36	3.18	3.38
601 – 700	3.33	3.33	3.11	3.44
701 – 900	3.41	3.43	3.19	3.50
901 – 1000	3.39	3.40	3.19	3.49
1001 – 1500	3.33	3.33	3.06	3.43
1501 – 2000	3.36	3.33	3.06	3.44
2001 – 2500	3.28	3.24	2.97	3.34
2501 – 3000	3.36	3.31	3.03	3.40
3001 – 3500	3.17	3.11	2.83	3.23
3501 – 4000	3.50	3.41	3.07	3.54
4000 – 4500	3.24	3.18	2.89	3.24
4501 – above	4.08	3.83	3.39	4.27

[15] The most recent available table is for 1975/76.

Table 15. Incidence of sales taxes

Income groups (Rs per month)	*Tax paid/income*			
	1987/88	*1988/89*	*1989/90*	*1990/91*
Upto 600	1.34	2.01	2.25	1.94
601 - 700	1.33	1.97	2.25	1.94
701 - 900	1.44	2.04	2.38	2.05
901 - 1000	1.38	1.98	2.29	1.97
1001 - 1500	1.32	1.96	2.29	1.97
1501 - 2000	1.35	2.00	2.34	2.02
2001 - 2500	1.29	1.94	2.27	1.96
2501 - 3000	1.35	2.01	2.33	2.00
3001 - 3500	1.25	1.96	2.30	1.98
3501 - 4000	1.33	1.14	2.50	2.16
4001 - 4500	1.31	2.06	2.39	2.06
4501 - above	1.17	2.16	2.57	2.21

Table 16. Incidence of custom duties

Income groups (Rs per month)	*Tax paid/income*			
	1987/88	*1988/89*	*1989/90*	*1990/91*
Upto 600	2.41	2.53	2.99	2.50
601 - 700	2.87	2.85	3.19	2.66
701 - 900	3.03	2.90	3.22	2.69
901 - 1000	2.90	2.80	3.05	2.54
1001 - 1500	3.13	2.94	3.14	2.62
1501 - 2000	3.22	2.98	3.17	2.65
2001 - 2500	3.09	2.84	2.98	2.49
2501 - 3000	3.13	2.85	2.99	2.50
3001 - 3500	3.13	2.83	2.95	2.46
3501 - 4000	3.61	3.23	3.33	2.78
4001 - 4500	2.93	2.63	2.80	2.35
4501 - above	4.90	4.32	3.70	3.02

Table 17. Incidence of income taxes

Income groups (Rs per month)	*Tax paid/income*			
	1987/88	*1988/89*	*1989/90*	*1990/91*
Upto 600	0	0	0	0
601 - 700	0	0	0	0
701 - 900	0	0	0	0
901 - 1000	0	0	0	0
1001 - 1500	0	0	0	0
1501 - 2000	0	0	0	0
2001 - 2500	0	0	0	0
2501 - 3000	0.02	0.02	0.02	0.02
3001 - 3500	0.02	0.02	0.02	0.02
3501 - 4000	0.18	0.18	0.18	0.20
4001 - 4500	0.09	0.09	0.09	0.10
4501 - above	1.40	1.42	1.35	1.54

Table 18. Incidence of indirect taxes

Income groups (Rs per month)	*Tax paid/income*			
	1987/88	*1988/89*	*1989/90*	*1990/91*
Upto 600	7.08	7.90	8.42	7.81
601 – 700	7.53	8.15	8.55	8.04
701 – 900	7.87	8.36	9.79	8.24
901 – 1000	7.67	8.18	8.54	8.01
1001 – 1500	7.78	8.21	8.48	8.01
1501 – 2000	7.93	8.31	8.57	8.11
2001 – 2500	7.65	8.01	8.22	7.79
2501 – 3000	7.83	8.17	8.34	7.90
3001 – 3500	7.56	7.90	8.07	7.67
3501 – 4000	8.45	8.79	8.90	8.47
4001 – 4500	7.47	7.86	8.07	7.65
4501 – above	10.14	10.31	9.66	9.50

Table 19. Incidence of both direct and indirect taxes

Income groups (Rs per month)	*Tax paid income*			
	1987/88	*1988/89*	*1989/90*	*1990/91*
Upto 600	7.08	7.90	8.42	7.81
601 – 700	7.53	8.15	8.55	8.04
701 – 900	7.87	8.36	8.79	8.24
901 – 1000	7.67	8.18	8.54	8.01
1001 – 1500	7.78	8.21	8.48	8.01
1501 – 2000	7.93	8.31	8.57	8.11
2001 – 2500	7.65	8.01	8.22	7.79
2501 – 3000	7.85	8.19	8.36	7.92
3001 – 3500	7.58	7.92	8.09	7.69
3501 – 4000	8.63	8.97	9.08	8.65
4001 – 4500	7.56	7.95	8.16	7.74
4501 – above	11.54	11.73	11.01	11.04

Table 20. The percentage increase in tax burden by income groups

Income groups (Rs per month)	*Percentage increase in tax burden as a percentage of income over 1987/88 to 1990/91*
Upto 600	10.3
601 – 700	6.8
701 – 900	4.7
901 – 1000	4.4
1001 – 1500	3.0
1501 – 2000	2.3
2001 – 2500	1.8
2501 – 3000	0.9
3001 – 3500	1.5
3501 – 4000	0.2
4001 – 4500	2.4
4501 – above	-4.3

Source: Based on table 18.

IV. CONCLUDING OBSERVATIONS

Pakistan's tax structure is heavily oriented towards indirect taxes; direct taxes account for less than one fifth of tax revenues and only about 2 per cent of GDP. Ever increasing reliance on indirect taxes has reduced both the elasticity as well as progressivity of the tax structure of Pakistan.

Small tax base on which direct taxes are levied and tax evasion have been responsible for relatively smaller revenues from the direct taxes. Most of the corporate income from the new industrial units and the income from the government sponsored financial schemes are exempt from payment of income taxes. Agricultural income tax for the first time has been introduced in 1994/95 in three provinces, but the Punjab province which account for 60 per cent of agricultural produce has not yet introduced the tax. Dividend income, export incomes, and contractor's incomes are taxed at a flat rate.

Customs duties continue to be the largest source of tax revenue accounting for more than one third of tax-revenue. During the 1980s, the significance of customs revenue had increased further, but in recent years, it has gone down somewhat. Statutory import duty rates in Pakistan are high but a very large proportion of imports either enter duty free or are subject to very low rates of duties. Accordingly, the effective duty rates are around 25 per cent on average.

High customs duties have presumably been imposed for protecting industries, curbing conspicuous consumption and generating more revenues but seem to have served hardly any of the three objectives. High import duties encourage smuggling and the misuse of facilities, and breed inefficiency. Accordingly, tariff rationalization needs to be accorded top priority for resolving these issues.

Excise duties are not being used as a consumption tax for sumptuary purposes in Pakistan; it is just a tax on domestic production. An attempt was made in 1990/91 to levy excise on capacity basis to overcome administrative problems and to encourage production of these goods. However, the experience with capacity taxation has been rather poor and has been abandoned. Specific duty rates have also been converted into ad-valorem rates in the 1994-1995 budget.

Sales tax at present is not being collected at sales points. The Government intends to convert it into a value added tax, but has so far made no serious effort in that direction. However, the coverage of sales taxes has been broadened significantly in the last few year.

Changes in the tax structure over the last fifteen years, particularly in the last five years, have been motivated by the desire to mobilize resources and to improve efficiency, but equity has hardly been given any weight in effecting a change in the tax structure. Unfortunately, even the mobilization of resources has not materialized. Tax buoyancy with respect to GDP, despite large discretionary changes announced in various budgets, is still less than unity. Tax elasticity estimates are fraught with serious errors; yet estimates as low as 0.30 is indicative of serious flaws in the tax system.

Tariff rationalization process on the other hand has resulted in the improvement in levels of efficiency. The low rates of import duties has resulted in induction of new machines and import policies have allowed the industrialists an easy access to raw materials, with the result the domestic resource cost, has fallen by about 50 per cent.

Direct taxes accounted for only 17.9 per cent of additional taxes proposed in the 1988/89 to 1993/94 budgets indicating the continued reliance on indirect taxes for tax revenues. No doubt, Pakistan imposes higher excise and import duties on the goods consumed by the rich, yet the fact remains that smuggling and other forms of tax evasion reduce significantly the burden of tax on the rich. Similarly, any reduction in import duties on imports does not benefit the poor, because of the monopolistic market structure which do not allow the prices to fall. Recent changes in the tax structure have been quite inequitable – even though tax rates remain progressive. The estimates of incidence of taxes indicate a reduction of tax incidence by 4.3 per cent on the richest section of population and an increase by 10.3 per cent on the lowest income group compared to earlier years.

Obviously, the tax structure of Pakistan needs to be further rationalized. All the four major taxes need to be judiciously employed to serve different objectives. With a view to assigning one tax instrument to one objective, tariffs may be used to protect domestic industries, sales taxes to generate revenue, excise duties to curb consumption, and direct taxes, i.e. income and wealth taxes, to make the tax system equitable. Accordingly, following measures would help in enhancing efficiency and equity, curbing consumption and mobilizing resources:

(a) Tariffs may be rationalized in accordance with the needs of industry for overcoming the cost disadvantages. Tariff rationalization would result in the lowering of tax revenues but would improve industrial efficiency.

(b) Sales taxes (or value added tax) may be extended to all the products except essential food products. Sales taxes may be collected at sales point rather than at the import stage or the production stage. It would help in recouping the revenue lost through tariff rationalization.

(c) Excise duties may be imposed on both the domestic as well as the imported and smuggled goods. This would help in reducing consumption and at the same time in resource mobilization and in making the tax structure equitable.

PHILIPPINES

I. A PROFILE OF THE PHILIPPINE TAX SYSTEM

The structure and growth of tax revenue

As in other developing countries most of tax revenues in the Philippines (65.1 per cent in 1992) are generated by indirect taxes. The contribution of direct taxes however increased from a 32.5 per cent of total tax revenues in 1980 to 34 per cent in 1992. The income tax, unlike in many other developing countries, has been the single most important source of government revenue in the Philippines. Import duties have also remained an important source contributing almost a third of total tax revenues in 1992. However, the imposition of a temporary 9 per cent import levy (which was later scaled down to 5 per cent) in 1991 was reflected in increased share of an important duties in government financing. The value-added tax (VAT) and other business taxes ranked third in raising only 13.3 per cent of total revenue in 1992. The proportion of revenues contributed by excise taxes on fuel, alcohol and cigarettes were also of the same order of magnitude. A host of minor taxes are also imposed by the Government, such as taxes on transfer of properties, motor vehicles, travel, and documents. Together, they only contributed 7.4 per cent of total tax revenue in 1992 (table 1).

For a number of years, growth in revenue has lagged behind that of expenditures, giving rise to large budget deficits. National government expenditures grew by an average of 18.5 per cent in current prices during 1980-1985 while revenues grew by 16.2 per cent. During 1986 to 1992, expenditures grew by 20.4 per cent on the average compared to a 19.8 per cent growth in revenues. Faced with revenue limitations, the Government had to restrain growth in expenditure. Nevertheless, the inability of the revenue system to match the growth of expenditures resulted in rising budget deficits, the size of which rose from P 3.2 billion in 1980 to a peak of P 37.2 billion in 1990. The deficits have been financed largely through internal borrowings as international credit lines became increasingly tight.

The huge deficit of the national government was accompanied by a surge in the inflation rate, which reached a record 18.7 per cent in 1991 following the highest national deficit of P 37.2 billion in 1990. Interest rates went on an uptrend reaching 23.4 per cent in 1990, dropping slightly to 21.4 per cent in 1991 (figure 1). These developments had various adverse consequences for the country's economic performance as well as on poverty and equity.

The lackadaisical performance of the tax system, especially during the troubled years of the 1980s, is also reflected in the level of the tax efforts or the ratio of tax revenues to GNP (table 2). Owing to the political and economic problems of the early 1980s, the tax effort decelerated from 12.7 per cent in 1980 to a low of 9.5 per cent in 1984. The introduction of a Comprehensive Tax Reform Programme by the new Aquino government in 1986 improved tax performance and the tax-GNP ratio had reached 12.8 per cent in 1987. The momentum was not sustained however as the tax effort plunged to 11.4 per cent in 1988. Efforts to improve the situation continued however and the level of tax effort reached 15.2 per cent again in 1992. It must be mentioned that a significant in-

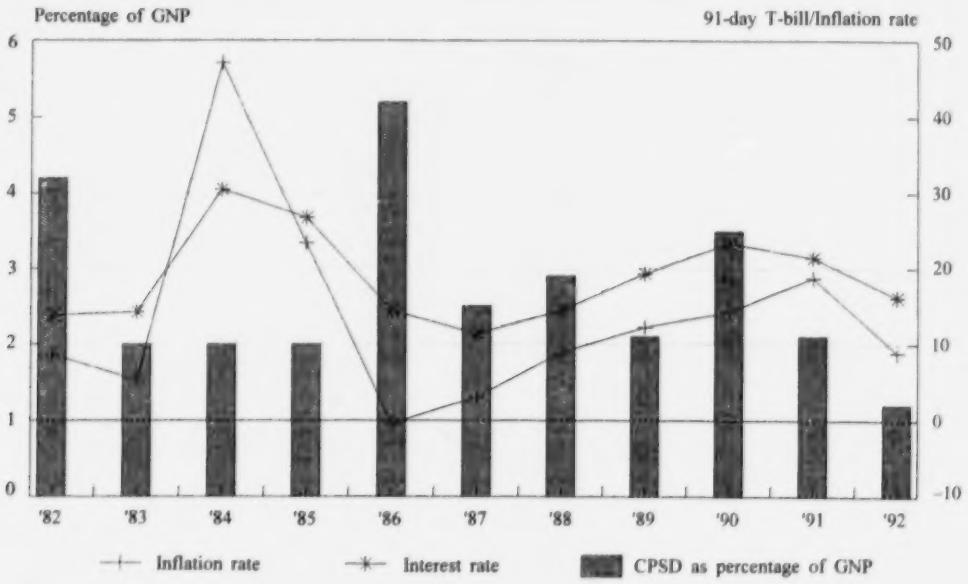
Table 1. Distribution of national government tax revenues by type of tax, 1980-1992
(In million pesos and in per cent)

Taxes	*1980*	*1981*	*1982*	*1983*	*1984*	*1985*	*1986*	*1987*	*1988*	*1989*	*1990*	*1991*	*1992*
Amount (in million pesos)	28 842	30 291	33 998	39 598	50 751	60 415	65 539	85 923	90 352	122 462	151 133	182 832	208 706
Direct taxes (in per cent)	32.45	35.59	32.45	24.84	28.37	31.81	31.76	27.31	32.81	32.91	34.33	34.64	34.86
Income taxes	30.51	32.85	29.45	22.19	25.83	29.47	29.29	25.37	30.34	30.70	32.66	33.39	33.60
Property transfer	0.26	0.15	0.15	0.26	0.21	0.11	0.13	0.07	0.09	0.10	0.13	0.09	0.12
Motor vehicles tax	0.99	1.97	2.07	1.78	1.55	1.65	1.61	1.30	1.39	1.19	1.02	0.80	0.77
Metro flood control tax	0.05	0.05	0.05	0.04	0.04	0.02	0.02	0.01	0.00	0.01	0.00	0.00	0.00
Fire code tax	0.07	0.04	0.09	0.05	0.05	0.03	0.03	0.02	0.02	0.03	0.05	0.03	0.03
Travel tax	0.14	0.13	0.17	0.09	0.39	0.35	0.49	0.32	0.63	0.44	0.41	0.31	0.33
Additional real property tax	0.42	0.49	0.47	0.44	0.30	0.17	0.19	0.21	0.34	0.44	0.06	0.01	0.00
Immigration tax	0.00	0.00	0.00	0.00	0.00	0.00	0.01	0.00	0.01	0.01	0.00	0.00	0.00
Indirect taxes (in per cent)	67.55	64.13	67.55	75.16	71.63	68.18	68.24	72.68	67.19	67.10	65.67	65.36	65.14
Excise taxes	18.42	16.66	14.87	16.03	20.48	22.32	25.00	26.35	21.69	20.30	19.11	13.89	13.24
Sales, license and business taxes/VAT[a]	19.14	10.16	10.31	12.41	12.96	12.65	14.11	14.12	13.68	12.81	13.41	13.25	13.32
Import duties	20.78	20.59	24.59	29.27	22.57	22.02	18.56	28.04	25.50	29.21	28.13	33.21	32.49
Import taxes	0.15	10.71	10.22	10.79	7.62	4.14	7.15	2.19	2.18	2.12	1.90	2.32	2.42
Export taxes	1.47	1.01	0.85	0.66	3.42	1.65	0.97	0.02	0.00	0.00	0.00	0.00	0.00
Documentary, science and stamp taxes	1.18	0.62	0.68	1.97	1.87	1.95	2.21	1.71	2.80	2.48	2.34	2.65	3.08
Forest charges	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.03	0.03	0.04	0.05	0.12
Special oil impost	0.00	3.81	2.54	2.64	1.94	0.17	0.00	0.00	0.00	0,00	0.00	0 00	0.00
Oil price stabilization fund	3.83	0.04	0.00	0.00	0.10	0.73	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Miscellaneous taxes	2.59	0.71	3.49	1.37	0.66	2.57	0.24	0.25	1.31	0.14	0.74	0.01	0.48

Source: Cash Operations Statement and Bureau of the Treasury, Department of Finance.

[a] VAT collections started on the 2nd quarter of 1988.

Figure 1. National government deficit, inflation rate and interest rate



crease in collection was made through imposition of temporary import and oil levies as crisis management measures starting 1991. Without those measures the tax/GNP ratio would have plunged to 13.9 per cent only.

The imposition of exigency levies on imports pushed the share of import duty in tax revenue from 18.6 per cent in 1986 to 33.2 per cent in 1991 and as a ratio to GNP from 2.0 per cent in 1986 to almost 5 per cent in 1992 (table 2). The income tax share in GNP rose from 3.2 per cent in 1986 to 5.1 per cent in 1992. The VAT, with a contribution of 1.6 per cent of GNP in 1988, i.e. the year it was introduced and 2 per cent in 1992 showed promise as a source of revenue. A decline in excise taxes as a proportion of GNP was contrary to expectation after the excise taxes were converted from specific to ad valorem rates. Within a scenario of increasing volume of production of exciseable products, the lackluster performance was indicative of inefficiencies in tax administration and a lax in tax compliance.

Buoyancy estimates provide optimism that the tax system is capable of generating enough revenues (table 3). Marked improvement in the revenue performance of tax system can be observed from 1986 to 1992 as buoyancy of total tax revenue increased from 0.85 to 1.36. The flexibility of revenue from the income tax, particularly the personal income tax, is remarkable. A buoyancy coefficient of 1.99 shows that collections from the personal income tax grew in greater proportion relative to increase in income. Buoyancy for customs duties increased from 0.86 to 2.2 reflecting however the exigency measures introduced by the Government to improve collection of customs duties.

Low buoyancy estimates for the VAT and excise taxes are strong signals that major improvements are needed in tax structure and tax administration. With a tax buoyancy of

Table 2. Ratio of tax revenues to gross national product by type of tax, 1980-1992
(In per cent)

Taxes	*1980*	*1981*	*1982*	*1983*	*1984*	*1985*	*1986*	*1987*	*1988*	*1989*	*1990*	*1991*	*1992*
Total tax revenues	11.86	10.80	10.84	10.90	9.98	10.86	10.99	12.81	11.41	13.40	14.01	14.48	15.23
Direct taxes	3.85	3.85	3.52	2.71	2.83	3.46	3.49	3.50	3.74	4.41	4.81	5.02	5.31
Income taxes	3.62	3.55	3.19	2.42	2.58	3.20	3.22	3.25	3.46	4.11	4.58	4.84	5.12
Property transfer	0.03	0.02	0.02	0.03	0.02	0.01	0.01	0.01	0.01	0.01	0.02	0.01	0.02
Motor vehicles tax	0.12	0.21	0.22	0.19	0.15	0.18	0.18	0.17	0.16	0.16	0.14	0.12	0.12
Metro flood control tax	0.01	0.01	0.01	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Fire code tax	0.01	0.00	0.01	0.01	0.01	0.00	0.00	0.00	0.00	0.00	0.01	0.00	0.00
Travel tax	0.02	0.01	0.02	0.01	0.04	0.04	0.05	0.04	0.07	0.06	0.06	0.05	0.05
Additional real property tax	0.05	0.05	0.05	0.05	0.03	0.02	0.02	0.03	0.04	0.06	0.01	0.00	0.00
Immigration tax	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Indirect taxes	8.01	6.94	7.32	8.91	7.15	7.41	7.50	9.31	7.67	8.99	9.20	9.47	9.92
Excise taxes	2.18	1.80	1.61	1.75	2.04	2.42	2.75	3.38	2.47	2.72	2.68	2.01	2.02
Sales, license and business taxes/VAT[a]	2.27	1.10	1.12	1.35	1.29	1.37	1.55	1.81	1.56	1.72	1.88	1.92	2.03
Import duties	2.46	2.22	2.67	3.19	2.25	2.39	2.04	3.59	2.91	3.91	3.94	4.81	4.95
Import taxes	0.02	1.16	1.11	1.18	0.76	0.45	0.79	0.28	0.25	0.28	0.27	0.34	0.37
Export taxes	0.17	0.11	0.09	0.07	0.34	0.18	0.11	0.00	0.00	0.00	0.00	0.00	0.00
Documentary, science and stamp taxes	0.14	0.07	0.07	0.21	0.19	0.21	0.24	0.22	0.32	0.33	0.33	0.38	0.47
Forest charges	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.01	0.01	0.02
Special oil impost	0.00	0.41	0.28	0.29	0.19	0.02	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Oil price stabilization fund	0.45	0.00	0.00	0.00	0.01	0.08	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Miscellaneous taxes	0.31	0.08	0.38	0.15	0.07	0.28	0.03	0.03	0.15	0.02	0.10	0.00	0.07
GNP (in million pesos)	234 270	280 543	313 544	363 268	508 485	556 074	596 276	670 826	791 822	914 126	1 078 408	1 262 358	1 370 379

Sources: Annual Financial Report of the National Government, 1980-1986, Commission on Audit; Budget of Expenditures and Sources of Financing, 1987-1992; and National Statistical Coordination Board.

[a] VAT collections started on the 2nd of 1988.

Table 3. Buoyancy coeffficient of major taxes, 1980-1990

Tax	*1980-1985*	*1986-1990*
Total	0.85	1.36
Income tax	0.72	1.58
Personal	1.11	1.99
Corporate	1.90	1.36
VAT	0.32	0.48
Import duties	0.86	2.18
Excise	1.18	0.50

Source: Department of Finance. Staff Calculations.

0.48, the VAT collection remains far from ideal. A drop in the buoyancy of excise taxes from 1.2 in the early 1980s to 0.50 from 1986-1990 is a strong indication of inefficiencies in their administration. The under-performance of the VAT is accounted for by the wide array of exemptions and exclusions from the tax base as well as weaknesses in its administration.

Characteristics of major taxes

The individual income tax

The individual income tax in the Philippines basically follows a schedular approach unlike in many other countries. Different types of incomes are taxed using different bases and different rates. Fixed-income earners are taxed using the modified gross income (MGIT) base, i.e. gross income less personal and additional exemptions. The tax rates range from 0 to 35 per cent with 10 taxable brackets.

Business and professional income earners are taxed using a Simplified Net Income Tax Scheme (SNITS). In addition to personal exemptions, taxpayers are allowed to claim direct costs as deductions. These are expenses for raw materials, electricity, water, salaries, rental, and other direct costs. Expenditures on representation, travelling, advertisements, and bad debts, are not allowed to be claimed as deductions. There are also limitations in claiming interest payments and charitable contributions as deductible expenses for income tax purposes. For example, deductions can only be claimed for contributions made to rehabilitation programmes in nationally proclaimed disaster areas. The applicable SNITS rates range from 3 to 30 per cent with only five tax brackets.

Passive incomes are separately taxed as follows:

- Interest income, royalties, and prizes exceeding P 3,000 are subject to a 20 per cent final withholding tax on gross.
- Capital gains on real properties are charged at a 5 per cent final tax on the gross sales value, or fair market value of the property.
- Capital gains from the sale or exchange of shares or stocks which are listed or traded in any local stock exchanges are exempt from income taxation. They

are however subject to a stock transaction charge of 1/2 of 1 per cent. Capital gains from unlisted stocks are taxed at rates ranging from 10 to 20 per cent.

Dividends which are distributed to resident citizens are exempt from the income tax. An income tax is also payable by aliens who are engaged in trade or business in the Philippines. They are taxed like resident citizens on their incomes from Philippine sources. Non-resident aliens who are engaged in trade or business in the Philippines are subject to a 30 per cent tax on their gross incomes which are received from Philippine sources.

Personal exemptions are given with the intent of exempting families who live below the poverty threshold from income taxation. The exemption levels vary depending on the civil status of the taxpayer and the number of dependents. They range from P 9,000 for a single taxpayer to P 18,000 for a married taxpayer. An additional exemption of P 4,000 can be claimed for each dependent upto a total of four. With these provisions, a family with four children with total annual income of P 52,000 remains exempt from income taxation.

The corporate income tax

Domestic corporations are subject to a tax on their net worldwide income at 35 per cent. All ordinary and necessary expenses paid or incurred during the tax year in carrying out any trade or business are deductible from gross income. Expenses are considered ordinary and necessary if they are appropriate and helpful in generating profit.

Subsidiaries of foreign corporations are taxed just like domestic corporations with a provision that any foreign tax paid on income from foreign sources can be claimed as a tax credit subject to certain limitations. Resident foreign corporations which are incorporated under foreign laws but are engaged in trade or business in the Philippines are referred to as the Philippine branch of a multinational corporation. As such, they have no separate legal personalities from their head office. They are taxed on their net income from Philippine sources at 35 per cent. Any profit remitted by a branch to its head office is subject to a tax of 15 per cent, except those which are registered in the export processing zone.

There are corporate entities which are subject to preferential rates, including the following:

- International carriers doing business in the Philippines pay a 2 1/2 per cent final tax on gross Philippine billings.
- Philippine incorporated mutual life insurance companies are subject to a 10 per cent tax on gross investment income.
- The gross Philippine income of non-resident cinematographic film owners, lessors, or distributors are subject to a 25 per cent final withholding tax.
- Rentals, lease, and charter fees payable to non-resident owners of vessels chartered by Philippine nationals are subject to a 4 per cent final withholding tax.
- Offshore banking units are exempt on offshore income but are subject to a 10 per cent final tax on onshore income.

Other direct taxes

The other direct taxes imposed by the Government are the transfer taxes and the real property tax. The estate tax is imposed on the fair market value of the net estate at rates ranging from 5 to 35 per cent. Tax is imposed on the transfer of property by gift at rates ranging from 1.5 to 20 per cent.

The real property tax is imposed and collected by local governments on the assessed value of lands, buildings and improvements, ranging from 1 to 2 per cent. The assessed value is a percentage of the market value of the real property and is differentiated according to land use. For example, the assessed value for commercial and industrial lands is 50 per cent of their market value. Additional impositions are also attached to real properties, such as the Special Education Fund tax at 1 per cent and the idle land tax at 5 per cent.

The value-added tax

The VAT, which was introduced in the Philippines in 1988, replaced a complicated network of indirect taxes. The VAT took the place of the manufacturer's sales tax, the turnover tax, and the advance sales tax. The VAT was designed to minimize, if not eliminate, the cascading taxation of goods and services as they moved through different stages of production and distribution. It was also intended to enhance efficiency in the allocation of resources.

The Philippine VAT is of the consumption type and covers all goods and services including imports. It is computed using the tax credit method whereby input taxes paid by a trader are deducted from the VAT due. A standard rate of 10 per cent is imposed with a provision for the zero-rating of exports. Exemptions from VAT have been limited particularly with the introduction of the 1994 VAT reform law. The exempt items only include agricultural products when sold by the farmer, food products in their original state, utilities, education and medical services, and small firms.

An excise tax of 20 per cent is imposed on non-essential commodities in addition to the VAT. These include jewelry items, perfume, and yachts and other vessels intended for sports.

The excise taxes

The major products which are subject to excise taxation are petroleum, cigarettes, and alcoholic beverage.

Petroleum products are taxed at specific rates which are differentiated. Diesel fuel oil, which is used by public utility vehicles, is subject to a lower rate of P 0.45 per liter while higher rates are imposed on regular and premium gasoline at P 2.28 and P 2.52 per liter respectively. Liquified petroleum gas and bunker fuel oil are exempt from excise taxation.

The tax rates on cigarettes and alcoholic beverages are also varied and differentiated. The tax rates on locally manufactured cigarettes bearing a foreign brand name is 55 per cent compared to 45 per cent borne by a local brand. A 20 per cent tax rate is imposed on lower

priced cigarettes. Specific rates at P 5.00 per pack of foreign brand cigarettes and P 3.00 per pack of local brand, have been prescribed by the Government in order to forestall under-valuation of the tax base. An excise tax of 60 per cent attaches to beer. Distilled spirits and wines are subject to fixed tax rates with the highest rate of P 26.00 being imposed on sparkling wines.

Automobiles are subject to graduated ad valorem rates ranging from 15 to 100 per cent of the manufacturer's selling prices in addition to the VAT. The excise taxes on commodities subject to them are imposed in addition to the 10 per cent VAT.

Customs duties

Customs duties are imposed on imported goods in accordance with their classification under the Tariff and Customs Code. The Government introduced a tariff reform programme in 1981 to rationalize the tariff schedule and bring it down to a 10 to 50 per cent range. The programme aimed to reduce the level of effective tariff protection and to strengthen the competitiveness of domestic firms. A further programme was introduced recently for a gradual reduction of tariff rates within a five-year period, from 1991 to 1995.

II. EXPERIENCE IN TAX SYSTEM REFORMS

Over the years, the tax system has aimed to be productive, equitable and efficient. However, problems inherent in the system have constrained it from fully accomplishing these objectives. The narrow tax base, inequitable distribution of tax burden and tax induced distortions in resource allocation have persisted. The use of taxation for varied purposes weakened revenue-raising potential of the tax system and complicated its structure and administration.

The erosion of the tax base has been the result of exclusion of many activities from taxation in an attempt to direct resources to preferred areas of investment. Certain sectors have been granted tax exemptions, such as firms registered with the Board of Investments, cooperatives, labour unions, small mining companies, and those locating in export processing zones. Abuses associated with allowable deductions have also considerably weakened the tax base. According to some estimates, individual taxpayers claimed as much as 93 per cent of gross income as deductions, while deductions claimed by corporations ranged between 57 to 90 per cent.

The other problems relate to the non-declaration and under-declaration of incomes. There is no efficient mechanism which can reliably track incomes generated in the economy. The Philippines also uses a self-assessment system which relies heavily on the accuracy of income tax returns submitted by assessees. In reality, however, tax returns are far from accurate. A 1987 behavioral analysis of tax evasion reported that underreporting of income was a common practice among the self-employed taxpayers.[1] The same study also concluded that the tax ethics of the respondents or their predisposition to comply with their tax obligations was precariously low.

[1] National Tax Research Center, *A Study on Philippines Tax Administration* (1987).

The factors which have weakened the tax base have also introduced inequity into the distribution of the tax burden. Tax exemptions, the uncontrollable use of deductions, and tax evasion practices have not only weakened the revenue potential of the tax system. They have also distorted its fairness. Although, in general, the incidence of taxes in the Philippines can be considered as progressive, horizontal inequities existed. Taxpayers situated in similar circumstances end up shouldering different tax burden. In their tax incidence study[2] Yoingco, Guevara and Gracia observed that wage earners bear heavier tax burden compared to the self-employed and the professionals. The distribution of the VAT burden was also observed to be inequitable due to the failure of government to make VAT comprehensive. Attempts to introduce progressivity into the tax system through the use of varied tax rates have provided tax shelters to certain groups of taxpayers.

It has therefore been a constant challenge for Government to introduce tax reforms to enable the tax system to meet the requirements of development without sacrificing equity. Major reforms were introduced in the 1980s and are being further pursued.

Direct taxes

1981 reform of the income taxes

The Modified Gross Income Taxation (MGIT) is one of the most controversial and radical tax reforms which the Government had introduced in 1981 discontinuing the system of income taxation used in the country since 1919. The income tax regime prior to the introduction of MGIT, used the global net income approach where all of taxpayer's incomes were aggregated. Exemptions and deductible expenses were netted out, and progressive rate schedules ranging from 3 to 70 per cent were applied to tax net incomes. Revenue performance of the income tax was poor however under the system. From 1960 to 1981, the personal income tax was contributing only about 10 per cent of total revenue. Relative to GNP, the average share of income tax collections in the 1970s was only 2.51 per cent. By the country's own standards and those of countries similarly placed in the region, the performance of the income tax was below par.

The factors responsible for the under performance of the income tax was the problem of widespread evasion and abuse in the use of deductions. The results of the tax amnesty decrees were indicative of the gravity of these problems. For example, the number of people who took advantage of the amnesty on non-filing of returns in 1972 (2.15 million) was even bigger than the number of income tax filers in the same year.[3]

The MGIT was aimed to address these problems. It sought to broaden the income tax base, lessen the discretion available to taxpayers and tax examiners, and simplify tax compliance and administration.

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[2] Angel Q. Yoingco, Milwida M. Guevara and Joyce P. Gracia, "A study on the incidence of the Philippine fiscal system" (a study conducted for the development planning and research project of NEDA funded by UNDP) (December 1992).

[3] Angel Q. Yoingco, *The Dynamics of Income Tax Reform: The Philippine Experience* (Manila, GIC Press, 1985).

A decision was made to adopt a schedular instead of a global approach to income taxation. Although the theoretical superiority of the global approach was recognized, the conclusion was drawn that given the existing constraints, it could not work efficiently in the Philippines. The constraints related to problems in monitoring and recording incomes and business transactions, a low level of honest tax compliance, and inefficiencies in tax administration.

Under the schedular approach, individual incomes were grouped into three categories: 1) compensation incomes; 2) incomes from business, trade, and the exercise of professions; and 3) passive incomes. Compensation income is derived from an employer-employee relationship while business income is earned from running a business or exercising one's trade or profession. Passive income is derived from sources where the recipient only "plays a passive role, merely sitting back and waiting for it to come to him, e.g. interest, rental income and dividends."[4] Recognizing these distinctions as well as the differences in the nature of deductions which are related to each type of income, different tax bases and tax rate schedules were prescribed.

The concept of gross income taxation was introduced initially for compensation and passive incomes. Its major selling points was its simplicity which could enhance compliance and ease administration. There were other behavioral and economic advantages to gross income taxation. Compared to a net income taxation with many discretionary allowable deductions that placed a premium on certain expenses, a gross income tax was considered more efficient and equitable.

Gross income taxation was not adopted in its pure form since taxpayers with compensation income were allowed to claim personal and additional expenses. These represented the minimum requirements for subsistence which the Government freed from taxation. Other deductions were disallowed and "were built into the tax rates." With a broader income tax base, a lower rate schedule was adopted, i.e. 0 to 35 per cent in contrast with the former 3 to 70 per cent rate schedule.

Net income was used as the base for taxing business, trade, and professional incomes, and therefore higher tax rates of 5 to 60 per cent was used. A 15 per cent tax was imposed on passive income, which was considered preferential as higher marginal rates would apply if dividends and interest were aggregated with a taxpayer's global income. The preferential rate was an attempt to use taxation to encourage savings and investments. To address the rampant practice of non declaration of passive incomes, they were subjected to a final withholding tax scheme.

The use of the schedular system, particularly the adoption of the modified gross income tax approach, significantly improved the productivity of the income tax. Tax collection on passive income, for example, jumped by 1,357 per cent in 1982, a year after the final withholding tax scheme was introduced. Reform however was incomplete, the tax bases lacked rationalization, and distribution of tax burden remained inequitable with heavier burdens falling on salary and wage incomes.

[4] International Bureau of Fiscal Documentation, *Tax Glossary* (1988).

The 1986 tax reform package

The 1986 Tax Reform Package (TRP) was a marked departure from a piecemeal and fragmented revision of the tax system. It was a comprehensive and a structural approach in tax reform planning. The TRP provided the linchpin of economic recovery programme of the Aquino government in 1986 and was aimed primarily at improving equity, and promoting efficiency and growth. It consisted of 29 measures including long-term structural reform measures. These included exemption of taxpayers whose incomes are below the poverty line, the provision for income splitting of married couples, the abolition of taxes which caused a drag on growth, such as the export tax and the turnover tax, and the adoption of the value-added tax.

The income tax reforms

The TRP prescribed a uniform rate schedule of 0 to 35 per cent for compensation and business incomes abolishing the existing rate differentiation on the two types of income, and raised the tax rate on all forms of passive incomes from 15 to 20 per cent. Dividends were freed from taxation in order to avoid its double taxation, i.e. its taxation at the corporate level and in the hands of the shareholder. The use of uniform tax rates for business and compensation incomes was premised on the prescription of ceilings on certain deductible expenses from business incomes, particularly those expenses from business incomes most open to abuse such as promotional, representational, for travel and for charitable contributions.

Separate taxation of married couples was instituted by the TRP. Under the practice of joint income taxation, marriage automatically increased each of the spouses' tax liability. The aggregation of their income pushed them into higher taxable brackets and higher marginal rates. This strengthened the disincentive effect of taxation. The TRP allowed couples to compute their income separately so that each one could benefit from the progression of the rates from 0 to 35 per cent by a lowering of their taxable income brackets. The policy of exempting families with incomes below the poverty line was instituted by the TRP. This level was established at P 24,000 (US$ 873.00) in 1986.

The TRP also prescribed a uniform rate of 35 per cent tax on corporate income. The dual tax rate system used before, with a lower rate on corporations net earning of P 100,000 or less, invited underdeclaration of corporate incomes. The Philippines adopted the uniform corporate tax rate which is a common practice in many countries in the region, such as Australia, New Zealand, Malaysia, Singapore and Thailand. More recent reforms in these countries however further lowered corporate tax rates (27 per cent in Singapore and 30 per cent in Thailand) below those in the Philippines and Indonesia (table 4).

With the proliferation of tax incentives came the weakening of equity and efficiency of the tax system. This was particularly heightened by the grant of tax incentives for political purposes. The TRP corrected these by withdrawing all tax and duty incentives except those provided in the basic tax codes, those granted under international agreements, and those administered by the Board of Investments. A subsidy scheme was instituted in order to make the system of "tax expenditures" more transparent, efficient, and accountable.

The 1985 tax incidence study of Yoingco observed that for all income levels, the tax burden on fixed income-earners was relatively heavy. For taxpayers earning P 100,000 or

Table 4. Changes in the corporate tax rates in some Asian countries, 1980-1993

Country	*Old rates*	*New rates*
Australia	39	33
Indonesia	20, 30, 45	15, 25, 35
Japan	30 and 42	28 and 37.5
Republic of Korea	20 and 30	20 and 34
Malaysia	35	34
New Zealand	45	33
Philippines	25 and 35	35
Singapore	31	27[a]
Thailand	35 and 45	30

[a] Effective 1994 year of assessment, including passive incomes and management and director's fees paid to non resources.

1992 - 30 per cent.
1993 - 31 per cent.

more, salary earners paid 10.61 per cent of their income as income tax, whereas a taxpayer with business income paid only 1.14 per cent of his income as tax. On the average, the income tax burden of fixed-income earners was 2.86 per cent of their gross income compared with 0.63 per cent on business income earners. This inequity was brought about by the facility and latitude of discretion available to business income earners in claiming deductions. One form of control was the prescriptions of ceilings on business deductions. However, the proposed ceilings were not institutionalized.

The reform measure called the "Simplified Net Income Tax System" or SNITS was therefore directed towards a restructuring of income taxation of the self-employed and those receiving trade or business income. It was presented as a "cleansing" of the inequity in the individual income tax system. The SNITS was also intended to eliminate "private deals" and "under the table" transactions between the tax examiner and the taxpayers.

The SNITS have three major features:

(a) It broadened the income tax base through the disallowance of deductions which are subject to abuse and discretion. These included expenses for advertising and publicity; transportation, entertainment, and representation; bad debts; charitable contributions; and, other indirect costs. In effect, only direct costs such as for raw materials, labour, electricity, light, water, rental, and depreciation, are allowed to be claimed as deductible expenses. For firms whose costs of goods are difficult to determine, 35 per cent (which Congress later increased to 40 per cent) of gross income or gross sales are allowed as deductions.

(b) It adopted a fewer and wider taxable brackets and lower tax rates The SNITS rates, as approved by Congress, range from 3 to 30 per cent with only five tax brackets. The rate schedule is different from the 0 to 35 per cent rate range on wage-earners. This disparity was acknowledged with the intention of adopting the SNITS rate structure for wage-earners the following year, which however was not carried out thus far. The rates for compensation income thus remained

at 0 to 35 per cent applicable to 10 different income brackets while the rates for business and professional incomes ranged between 3 to 30 per cent applicable to 5 different brackets.

Basic to the design of the SNITS tax rate structure was the limitation that the SNITS should be at least revenue-neutral. The policy was also to design fewer tax brackets and lower marginal rates in order to reduce the disincentive effect of taxation on productivity and work efforts. Such simplification of rates and taxable income brackets have been a common feature of tax reform measures in countries of the region (table 5).

(c) The use of presumptive income levels (PILs) was introduced to help establish the incomes of the self-employed. The PILs will be set through the use of indicators such as the number of employees, the level of inventory, the number of clients and amount of fees charged. They will also be estimated in consultation with the different chambers, industry associations, and professional groups.

The SNITS thus restructured the personal income tax system by adopting the modified gross income tax approach (which is used for compensation income earners) for the self-employed. With a broader tax base, it was expected that more income tax can be collected from business income earners resulting in a more equitable distribution of the tax burden. The SNITS structure would, in effect, raise the effective tax rates (ETRs) on the self-employed from all income levels particularly those from the higher income classes (figure 2).

The SNITS reform was not carried out in full. The concept of PILs was not approved by the Legislature. The 35 per cent maximum allowable deduction was also increased to 40 per cent. The SNITS base was also diluted with the inclusion of other items which can

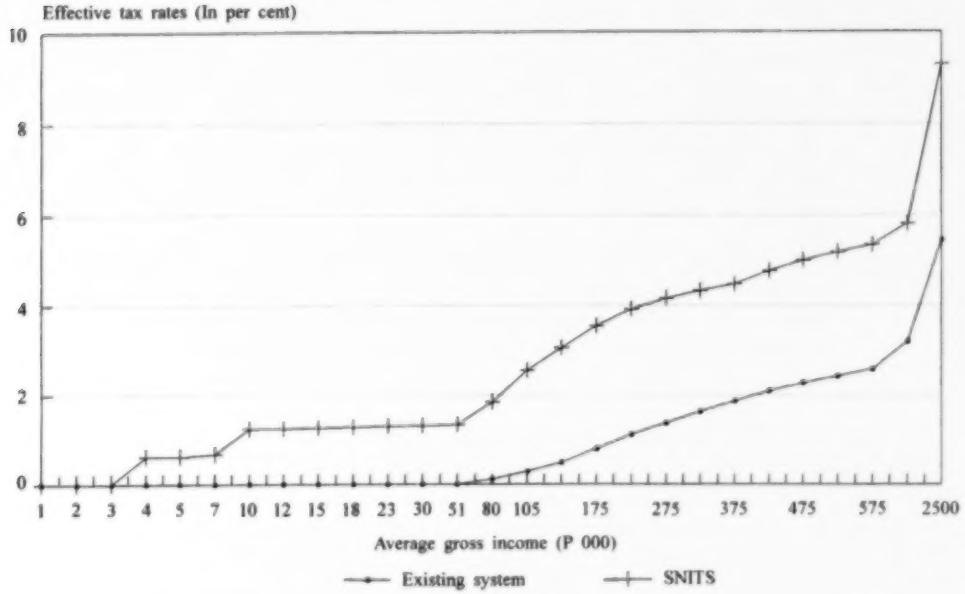
Table 5. Summary of changes in the individual income tax structure in some Asian countries from 1980 to 1993

Country	*Tax rates (per cent)*		*Tax brackets*	
	Old	*New*	*Old*	*New*
Australia	–	20–47[a]	–	4
Indonesia	5–50	15–35	19	3
Japan	10–60	10–50	12	5
Republic of Korea	6–55	5–50	16	5
Malaysia	4–35	2–34	9	9
New Zealand	20–66	24–33	6	2
Philippines	3–70	Fixed income earners		
		0–35	37	10
		Self-employed		
		3–30	37	5
Singapore	3.5–33	2.5–30[b]	14	14
Thailand	7–55	5–37	11	5

[a] Plus medicare levy of 1.25 per cent of taxable income in old brackets. Proposed to be reduced by November 1993.

[b] Assessment to take effect in 1994.

Figure 2. Effective tax rates under the current income tax system and the SNITS



be claimed as deductions, such as interest and contributions to Government for the rehabilitation of calamity-stricken areas. It is said however that this is normal for a tax reform; some things are lost in the process of legislation. What is important however is that the practice of safeguarding the integrity of the income tax base has been institutionalized.

Executive Order (EO) 226 (13 August 1987) consolidated various legal provisions for tax incentives and restructured the major forms of incentives. Prior to the reform, tax incentives were in the form of tax credits based on net value earned (NVE) and the net local content (NLC). The NVE was equal to the value of sales minus the costs of raw materials and depreciation of capital equipment while the NLC referred to the value of export sales minus the value of imported raw materials and depreciation. The EO reintroduced the tax holiday for promoted firms from four to six years. It also provided for a deduction of 50 per cent of incremental labour expenses for a five-year period. A premium was given to firms locating to less developed areas and they could claim an additional deduction.

The provision for an income tax holiday was premised on the need to simplify the tax incentive system as the NVE and NLC were complicated to administer. It was also designed to bring the incentive system in line with those offered by other economies in Asia.

The reform of the tax on transfer of property was designed to remove the disincentive effects of a steep progressive rate schedule. Prior to the reform, the estate tax rates ranged from 3 to 60 per cent with 16 tax brackets. In case of donation, the tax rate ranged from 1.5 to 40 per cent with 15 tax brackets. The tax did not produce much revenue accounting for only 0.19 per cent of internal tax revenue. The number of tax return filed was also decreasing over the years indicating, taxpayers reluctance to comply with the provisions of law.

It was quite clear that the objectives of the transfer taxes were not being met. Many transfers remained unexecuted due to the large amount of tax liability involved in the process of legitimate transfers. This development hampered the collection of the real property tax since a number of properties remained in the name of owners who had long been deceased. It was also possible that taxpayers entered into under-the-table deals with tax examiners to skirt around the law.

In line with the policy of minimizing the disincentive effect of taxation, the rates of the transfer taxes were reduced to 5 to 35 per cent for the estate tax and 3 to 20 per cent for the gift tax. The tax brackets were also reduced to only five for the estate tax.

Indirect taxes

The adoption of the value-added taxation

With barely one and a half year lead time since its announcement, the Government shifted to value-added taxation on 1 January 1988. The VAT replaced several indirect taxes including the manufacturer's sales tax, the advance sales tax, the compensating tax on imports, and a host of other taxes on goods and services. By so doing, the VAT simplified the complicated indirect tax structure in the Philippines. The economic reasons for introducing the VAT were equally as important. The VAT was aimed to eliminate the cascade in taxation as only the value-added in each stage of production and distribution is taxed. With the use of the invoice system of computing the VAT, input taxes on goods can be claimed as a tax credit, or refunded in the case of exports. Since the Philippine VAT is imposed at a uniform rate of 10 per cent, the VAT promotes neutrality in economic choices by preventing distortions in resource allocation.

The VAT was intended to be broad-based and comprehensive, covering all sales of goods and services, from their production and importation down to the retail stage. However, exemptions were provided to include the following: (a) agricultural food products in their original state and non-food products when sold by the farmer; (b) fertilizer and pesticides; (c) books, newspapers and magazines; (d) medical and educational services; (e) professionals, artists, actors and actresses; (f) sale and leasing of real property; and (g) small firms which are defined as those whose annual turnover does not exceed P 200,000 (US$ 7,272.00). Other activities excluded from the VAT coverage included franchise, catering, hoteling, transportation, and amusement. They continued to be subjected to tax at differentiated rates. Petroleum products were also outside the VAT base and subjected to excise taxes.

The VAT is imposed uniformly at 10 per cent except on export sales which are zero-rated. The rate was set at 10 per cent to enable the VAT to generate revenues equal to the collection from taxes which it replaced. The 10 per cent rate was also in line with the VAT rate in other Asian countries such as Indonesia and the Republic of Korea (10 per cent), New Zealand (12.5 per cent) and Thailand (7 per cent).

To mitigate the possible regressive effect of a uniform rate, a special excise tax of 20 per cent on certain non-essential products, such as yachts, perfumes and jewelry is imposed in addition to the VAT. Payment of such taxes cannot be claimed as a tax credit against the VAT due.

The Philippine VAT suffered from administrative problems in its initial year of implementation. Although it was intended to be an equal yield substitution tax, VAT in 1988 failed to generate revenue equal to the taxes it replaced. The VAT to GDP ratio in 1988 was only at 2.2 per cent lower than the 2.24 per cent collected from substitute taxes in 1987. It was only in 1990 that VAT revenue rose to 2.28 per cent of GDP and passed the revenue neutrality criterion. This notwithstanding, the VAT is still considered an underperformer with actual collection representing only 50 per cent of the potential. Estimates of VAT potential in 1992 reached P 63.8 billion relative to only P 32.4 billion of actual collection.

It is not difficult to account for the underperformance of the VAT. As earlier cited, there are a number of activities, particularly services, which are outside the VAT. Since services account for about 44 per cent of the GNP, its exclusion from the VAT is the surest way to make it unproductive and inequitable. The VAT is not also efficiently administered owing to the lack of adequate preparation for the reform. Taxpayers have yet to be fully informed of the nature of the VAT and its mechanics. Records have to be computerized and the discipline for the issuance of correct invoices has to be instituted.

Despite these shortcomings, the VAT has proved to be a superior alternative to the sales taxes which it replaced. The VAT significantly lowered the sales tax burden. The VAT cuts income of households by an average of 2.62 per cent as contrasted to an average effective tax rate (ETR) of 4.5 per cent of the former sales tax. It was also observed that the VAT resulted in lower taxation of inputs and, consequently, improvements in production efficiency.

A further VAT reform was enacted in 1994 in order to broaden the VAT base and improve its structure. The reform included most services and intangibles in the tax base: catering, hotelling, cargo, telephone and telegraph services, sale and lease of real estate, and among others. Exemptions have been pruned to include only agricultural products, small traders, fertilizer, and medical and educational services. The thrust of government efforts was focused on improving the administration and compliance to the VAT. These efforts however remained stalled upto this writing owing to some technical legal complications.

Reforms in excise taxation

The shift to ad valorem taxation for cigarettes and fermented liquor in 1986 was based on a simple assumption that its yield should rise proportionately with increase in prices. This expectation was not generally met however. Producers were underdeclaring values and used other means to avoid tax payment. In coming to terms with the problems, a shift to specific taxation was proposed on grounds that it is simple to administer and serves the sumptuary objectives better.

The dynamics in the legislative process however did not allow the enactment of the cigarette tax reform in its pure form. A compromise formula was instead legislated whereby floor tax rates were introduced. The floor tax in effect guaranteed that government would collect a minimum amount of tax per pack of cigarette.

The system of ad valorem taxation compounded the increase in the prices of oil products. During periods of rising oil prices, ad valorem taxation automatically led to higher taxes and an increase in the tax burden on consumers. The tax burden on oil products automatically rose with the peso devaluation.

In order to insulate the tax on oil products from the volatile changes in the oil prices and from fluctuations in the exchange rate, specific tax rates were prescribed. The original rates were proposed to be the peso equivalents of the ad valorem rates. Congress however legislated lower tax rates, particularly the rate on diesel oil, and freed liquified petroleum gas (LPG) from excise taxation. This development led to a decline in excise tax collection in 1991. Within a forthcoming scenario of oil price deregulation, the structure of excise taxation will have to be revised.

Reform in tax administration

Two major factors underscored the importance of tax administration in the Philippines recently. These are the problems of tax avoidance and the underperformance of the VAT. An intensive campaign against tax evasion was therefore launched and a better performance from the tax administrative machinery was demanded. As a result, the Bureau of Internal Revenue, the agency tasked with the collection of internal revenue taxes and the filing of criminal cases against suspected tax evaders, was reorganized. The Government also embarked on a five-year computerization programme for the BIR and the Bureau of Customs.

Tax collection procedures have been streamlined in a number of ways with regard to the collection of the VAT. A monthly payment and a withholding scheme for VAT payments were introduced by Republic Act (RA) 7643 (28 December 1992) and RA 7649 (6 April 1993), respectively. Instead of payment on a quarterly basis, the VAT was to be paid every month. The reform was intended to improve the cash flow position of Government.

Government agencies and government-owned and controlled corporations have also been required to withhold a 3 per cent VAT on gross payment for purchases of goods, and 6 per cent on gross payment for services rendered by contractors. The withholding scheme ensures the effective and timely collection of the VAT. With a view to improving revenue collections and minimizing the scope for corruption a scheme was devised to provide specified procedure for tax payment by large taxpayers. Tax payments from large taxpayers account for nearly 90 per cent of total tax collection of the BIR. By instituting a firmer control on large taxpayers, the Government ensures collection of a sizeable amount of revenues.

In the past tax examiners scrambled for assignments to audit large taxpayers. Cases of "hijacking" of tax returns of large taxpayers as well as their mysterious disappearance were reported. Taking a cue from the successful experience of Latin American countries, particularly Argentina, Uruguay, Peru and Colombia, Government required large taxpayers to pay their taxes in venues prescribed by the BIR Commissioner. A "Large Taxpayers' Unit" at the BIR was also created in order for timely and due collection of taxes without undue harassment to taxpayers.

A large taxpayer for this purpose is one whose income tax payment for the preceding year was at least one million pesos or whose excise tax due for the quarter is at least a million pesos. Under RA 7646, the BIR Commissioner may require him to pay his income tax in a designated office in Metro Manila. The law also empowers the Commissioner to designate other venues in the other two biggest islands, Visayas and Mindanao. The measure is considered transitionary and will only be implemented until the computerization programme is completed or within six years from 1993, whichever comes earlier.

In order to improve tax compliance, the penalties for tax evasion were increased steeply. In the past, penalties for tax evasion were relatively light and were described as merely a "slap on the palm". Thus, a profit maximizing taxpayer would have no reservations in cheating on his taxes since its costs are smaller than the corresponding benefits. RA 7642 (28 December 1992) confronted this problem by increasing the amounts of fines for tax evasion and made mandatory the penalty of imprisonment. It also provided that the penalties should at least be twice the amount of taxes, interests and surcharges due from the taxpayer.

The penalties for violations committed by government tax functionaries were also increased, such as imprisonment from 10 to 15 years and perpetual disqualification from holding a public office and participation in any public election. A great psychological impact was made when a ranking official of the BIR was convicted after the law was enacted.

To provide incentive for voluntary tax compliance, the BIR was mandated to publish the list of the top 4,000 corporations annually along with the total taxes paid by them. The rationale behind the measure is to spur public's consciousness for compliance of tax obligations. Using the Filipino cultural trait of "hiya" taxpayers with the greater capability to pay should be embarrassed if the community realizes that they pay very little taxes. The measure also envisions greater militancy among the community so that tax cheats can be censured. On the other hand, it stimulates the civic pride of the honest taxpayer.

To instill the importance of demanding sales invoices, the BIR conducts raffles using invoices as tickets. The public can join the raffle contest by dropping sales invoices in designated counters. Prizes such as cash and appliances are awarded to winners. To drum up national interest, the raffles are conducted in popular television shows.

The raffles have been successful in many ways. Not only have they encouraged the community to demand sales invoices, they have also given leads to BIR on "sham" and "fictitious" business establishments.

In order to encourage voluntary disclosure of undeclared tax base, the BIR instituted a "relative last priority" and "absolutely last priority" to taxpayers who came forward and declared their correct liabilities for income tax, the VAT and other business taxes. The taxpayer who availed of the programme enjoyed the privilege of being last to be subjected to audit and investigation. The privilege required that thereafter, the taxpayer should comply with the bookkeeping law, the keeping of accurate accounting records, and issuance of sales invoices. Deficiency taxes of the taxpayers are assessed in accordance with certain indicators such as the amount of inventory and the amount of taxes previously paid.

Importance has been placed on improving the management information and the computerization of tax administration. Government embarked on the development and installation of a computerized and integrated tax administration system to process and audit all payments. It will have the capability to integrate all taxes and data bases and allow crosschecking of tax information with data generated by other offices such as the Social Security System and the Securities and Exchange Commission.

The BIR computer system is based on decentralized tax collection by Regional District Offices and a central control, backup and auditing capacity at the national tax office. A large

mainframe will be installed at the central office of the BIR while all the regional offices will have communication systems, data entry and computing facilities.

Microcomputer systems will be installed in seven major ports in the country. The tax software will use an enhanced version of the Automated System for Customs Data Management (ASYCUDA ++) which has been developed by the United Nations Conference on Trade and Development (UNCTAD). The ASYCUDA ++ will be enhanced to help manage the duty drawback system and the bonded warehouse. The Bureau of Customs (BOC) computerization programme has a capacity to handle control of import and export processing, goods valuation, warehousing and the generation of trade statistics.

The computerization of tax administration is a five-year programme which commenced in 1993. The US$ 92.65 million project is assisted by the World Bank and is expected to significantly improve the simplification of systems and procedures and the development of a functional data base towards greater efficiency in the audit and collection of taxes.

A taxpayer identification number (TIN) was introduced in 1991. Prior to the issuance of the TIN, different types of numbering systems were used, e.g.: the Tax Account Number (TAN), the Assessment Number, the Withholding Agent number, the VAT Registration Number, and the Non-VAT Registration Number. This practice made data sharing very complicated, even within the BIR. To pave the way for an integrated computerization system, a single and a unique taxpayer identification number system was developed. Each taxpayer is issued a single TIN which should be used in all his transactions with the BIR and BOC. The TIN is used in cases of sale transactions, shipping, documents for property registration and transfers, registration of transport vehicles and equipment, and for obtaining building construction permits among others.

The use of the TINs in business documents would not only facilitate an audit trail for the BIR and BOC. It would also constantly remind taxpayers that business transactions are being monitored to ensure that the required taxes are correctly paid.

The VAT Information System or VATIS is a programme to computerize and systematize the administration of the value-added tax. The programme aims to monitor "vatable" transactions, identify non-filers, and track stop-filers. The VATIS has been piloted in two major revenue district offices: Quiapo and Mandaluyong-San Juan. The VATIS will be expanded nationwide as a component of the tax computerization project.

Vigorous efforts have been launched to develop a comprehensive tax roll. The first attempt to develop a functional tax roll was the "Operation Suyod" which was launched by the BIR in 1992. Literally, it meant using a fine-toothed comb to enable BIR personnel to identify all taxable activities and persons within their jurisdictions. This has been supplemented by a "Tax Mopping" project with the end of bringing taxable persons into the tax net including those who are operating in the underground economy. The project is also in support of the computerization of tax administration.

Under the project, teams from Revenue District Offices conduct a census of all taxable persons and firms within their respective jurisdictions. The teams update and harmonize existing lists of taxable entities including the list of taxpayers who have secured a Mayor's

permit (a permit to operate) from the office of the Chief Executive of the local government. In building the tax roll, the teams also make use of other data available from other government agencies such as landowners from the Registry of Deeds, names of practicing professionals from the Professional Regulatory Commission, and a list of employees from the different offices in the locality.

In support of the effort to develop a tax roll, the President issued Executive Order (EO) 53 (January 1993) which directs all government agencies to provide BIR with specific information.

A reorganization of the bureau of internal revenue has been undertake to improve its operation and efficiency. Studies on how to improve tax administration in the Philippines have underscored the centralization of functions in the BIR. This problem was highlighted in a Management and Performance Audit of the BIR which was conducted in 1992. The lack of a clear delineation of assessment functions was noted, considering that in addition to the regional tax offices, several divisions in the national office were also performing assessment and audit functions. The overlaps and duplications in functions inevitably resulted in inefficiencies, delays, and difficulties in identifying accountabilities. The creation of special audit teams by the national office had caused factionalism and chances of abuse.

The reorganization of the BIR, which was mandated by Executive Order 132 was in accord with the principle of decentralization. Its objective includes the streamlining of the organizational structure of the BIR in order to attain efficiency in tax collection and resource management.

The assessment and collection functions have been devolved to the 19 regional offices and 115 revenue district offices. Regional Directors have been granted authority to decide on tax cases. This power used to be vested solely on the Commissioner. The functions of the national offices have been streamlined focusing on planning and formulation of revenue targets and programmes. This meant abolishing central offices such as the Special Operations Service, Audit Divisions and the Excise Tax Service.

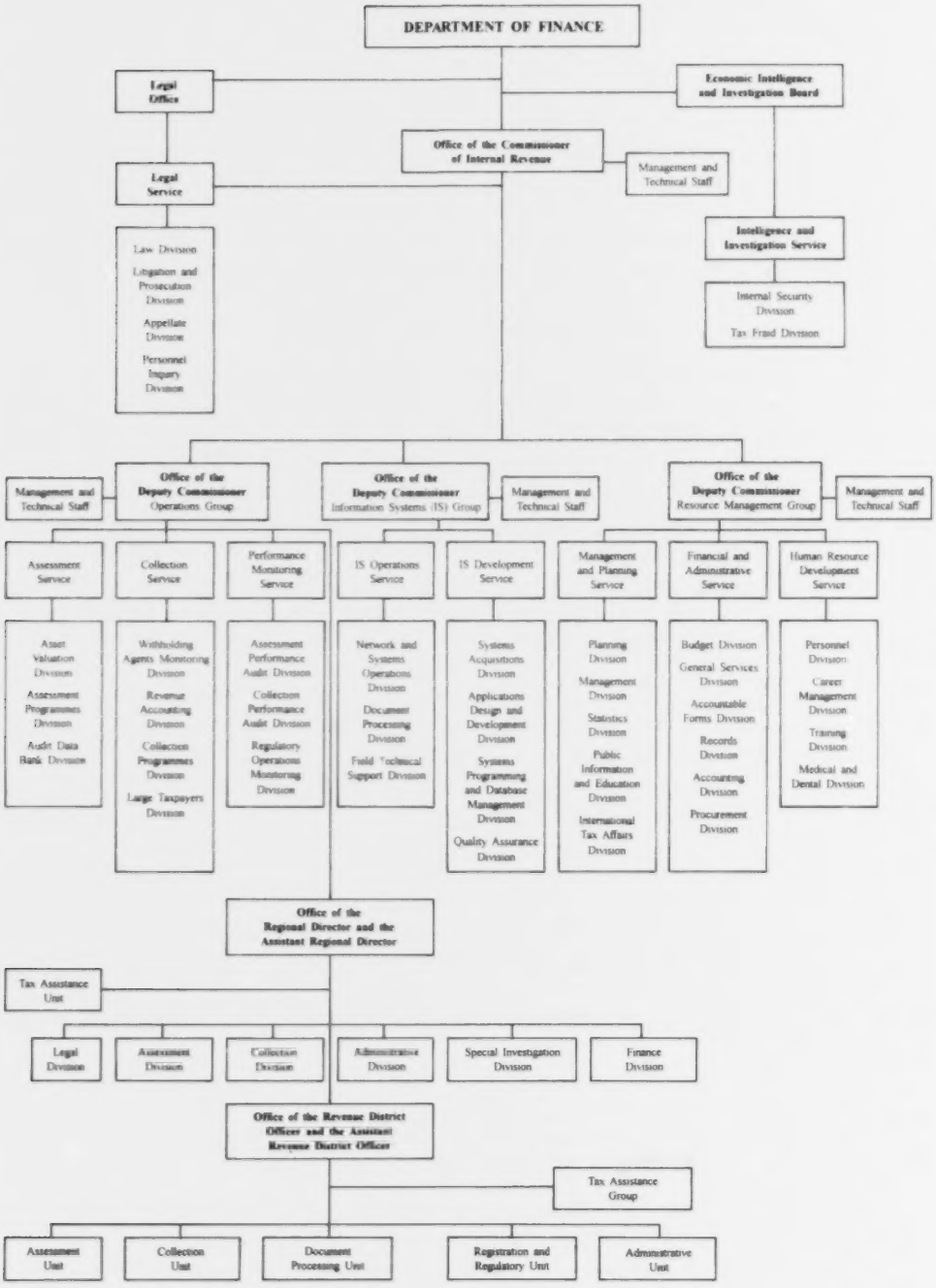
The office of the Commissioner has been restructured to put in place specialization and accountability. All the regional offices are under the supervision of the Deputy Commissioner for operations. One Deputy Commissioner is assigned to oversee the information systems in the BIR and the third deputy commissioner, handles resource management (figure 3).

Despite incremental gains however, greater efforts need to be exerted to further institutionalize the reforms in tax administration.

III. TAXATION, REDISTRIBUTION AND GROWTH

The effects of taxation on the allocation of resources is not adequately documented in the Philippines. This is because empirical studies on the subject has been sparse. The existence of many special incentive laws does not also permit a holistic view of the effects of taxation on resource allocation.

Figure 3. Bureau of internal revenue organization chart (Under E.O. 132)



The effects of taxation on equity, on the other hand, has been clouded with misconceptions. These include the penchant for steep progressive rates. For many legislators and the public, an equitable tax system is one with a progressive rate schedule. Such preoccupation even extends to the use of differentiated rates for foreign and domestically produced goods and for "essential" vs "non-essential" commodities.

There has to be a continuing effort to enable legislators and the public to understand that there is more to equity and efficiency than prescribing varied rates and granting exemptions. The indiscriminate use of varied rates and tax incentives may, in fact, lead to greater inequity and inefficiency since they affect resource allocation. Recent studies on taxation suggest that the tax system can affect the initial distribution of income through its effects on the structure of industry and demand for labour. In the long-run, taxation influences income distribution through its effects on savings, capital formation, and real wage levels.[5]

Taxation and resource allocation

The generosity with which tax incentives have been given by Government has created biases and distortions on resource allocation. Studies document that fiscal incentives promoted capital intensive and import substituting industries. They also penalized labour intensive exports and backward integration. In their study of the Philippine tax system in the 1970s, Bird *et al.*[6] observed that firms registered with the Board of Investments (BOI) were generally capital intensive in nature. The average level of fixed assets per employee in BOI firms ranged from a low of P 25,000 to P 651,000. In contrast, the ratio for small and labour intensive firms was P 137.00 per employee or roughly 1/1000th of that required for BOI firms. Employment generation which was directly attributable to BOI firms in the 1970s was also minimal, i.e. 0.3 per cent of the employed labour force.

The Ranis[7] mission (1974) confirmed the reduction in the cost of capital goods to firms by BOI incentives. It was inferred that they significantly contributed towards bringing about a lower rate of labour absorption for BOI firms. The study estimated that in the long-run, BOI incentives reduce employment growth by approximately 36 per cent from what it would have been without the incentives.

Since then, the incentive laws have undergone major revisions. However, the core of the incentive package remains the tax and duty exemption on importation of capital equipment. It is thus not surprising that the findings of more recent studies run parallel to the previous ones. Manasan estimated that the capital-related incentives of the 1987 Omnibus Investments Code reduce a firm's users's cost of capital by 26 to 35.5 per cent. An increase in the capital intensity of BOI projects was also observed. For processed food, for example, it was

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[5] Richard M. Bird and Barbara D. Miller, "Taxation, pricing and the poor" in *Government Policy and the Poor in Developing Countries* (Toronto, University of Toronto, 1989).

[6] Richard M. Bird, "Taxes and tax reform in the Philippines" (International Monetary Fund, 7 August 1974); and Richard M. Bird and Barbara D. Miller, ibid.

[7] Gustav Ranis (Chief of Mission), Inter-Agency Team organized by the International Labour Office, *Sharing in Development* (Geneva, 1974).

estimated that the capital-labour ratio increased from 119.72 in 1986 to 630.37 in 1992.[8] Other findings of the study are quite alarming: the concentration of BOI firms in the National Capital Region (NCR, i.e. Metro Manila) and regions III and IV in Luzon; and, the decline of the export market bias of BOI incentives in recent years.

The findings of other studies point to the mismatch between BOI incentives and the structure of the economy which results from the inability of BOI incentives to reach out to cottage, small and medium enterprises (MCSMEs).[9] Basically, the menu of incentives are not attuned to the needs of MCSMEs which are labor intensive in nature. MCSMEs are also unable to cope with the transaction costs in incentive availment because they are geographically dispersed and are mostly in rural areas. The application and administration of BOI incentives are generally done in Metro Manila.

The cheapening of capital in the Philippines through the grant of tax incentives is most unfortunate, given the abundance of its labour resource. The promotion of labour intensive industries is one means through which fiscal policies can help address the poverty problem.

The influence of fiscal incentives on locational decisions of firms to locate in Metro Manila, for example, is another area of serious concern. The problem of poverty is most acute in economically depressed regions. Regions far from Manila have more serious unemployment problems. The underemployment rate in Central Mindanao, for example, is 35.6 per cent relative to 5.9 per cent in NCR. A tax incentive system which attracts firms to locate in the metropolis is inconsistent with the objective of countryside development and does not address the problem of growth imbalance in the country.

It can also be said that the fiscal incentive system in the Philippines has not adequately compensated for biased tariff and foreign exchange policies. The present incentive system even withdrew the premium on exports by opening the privilege to import capital equipment free of tax and duty to exporters and non-exporters alike.

Nothing better could be said for special incentive laws. The application of these laws has been sporadic and bereft of a rational framework. The activities which have been promoted are varied and far-reaching. They encompass a wide gamut of programs, sectors and specific entities (table 6).

Almost all major programming of government are supported by incentives: the comprehensive agrarian reform, socialized housing, energy development, manpower training, and conversion of military facilities for development, to name a few. Even the breastfeeding programme is promoted through fiscal privileges. Participating institutions are allowed to claim a 200 per cent deduction on the expenses incurred in promoting breastfeeding. It appears therefore that the grant of tax exemptions is considered essential to the success of any government programme.

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[8] Rosario G. Manasan, "Breaking away from the fiscal bind: Reforming the fiscal system" (Philippine Institute for Development Studies, August 1993).

[9] Gwendolyn R. Tecson, "The effects of trade and industrialization policy on small enterprises: Analysis and proposals for legislative action" in *Macro Policies Affecting Small Enterprise Development in the Philippines* (Appropriate Technology International, 1991).

Table 6. Inventory of special laws granting tax incentives

Persons	*Sectors*	*Programmes*	*Organization*
1. Recalled diplomatic officials (RA 708)	1. Labour unions (RA 6715)	1. Comprehensive Agrarian Reform Programme (RA 6657)	1. Manila Jockey Club (RA 6631)
2. Returning filipino residents (RA 6768)	2. Countryside and Barangay Business Enterprises (RA 6810)	2. Industrial productivity programme (RA 6971)	2. Philippine Sports Commission (RA 6647)
3. Disabled persons (RA 7277)	3. Islamic Investment Bank (RA 6848)	3. Promotion of campus journalism (RA 7679)	3. Philippine Telegraph Telephone Corporation (RA 6970)
4. Veterans (RA 7291)	4. Cooperatives (RA 6938)	4. Development of mini-hydroelectric power (RA 7156)	4. People's Television Network, Incorporation (RA 7306)
5. Poor and deserving students (RA 7323)	5. Small-scale mining (RA 7076)	5. Bases Conversion Development (RA 7227)	5. Philippine Postal Corporation (RA 7354)
6. "Manlilikha ng Bayan" (RA 7355)	6. Iron and steel industry (RA 7103)	6. Socialized housing (RA 7279)	6. National Commission for Culture and the Arts (RA 7358)
7. Senior citizens (RA 7432)	7. Local water districts (RA 7109)	7. Seed industry development (RA 7308)	7. Bangko Sentral ng Pilipinas (RA 7653)
8. Filipino inventors (RA 7459)	8. Local government units (RA 7160)	8. Breastfeeding programme (RA 7600)	8. Experimental Cinema of the Philippines (EO 770)
9. Persons repatriating foreign currencies to the Philippines (RA 7498)	9. Rural banks (RA 7353)	9. Manpower training (RA 7696)	9. Coconut Oil Refiners Association (EO 1074)
10. Overseas contract workers (EO 25)	10. New and expanding BOI enterprises (RA 7369)	10. Use of coconut oil as diesel fuel extender (EO 827)	10. Armed Forces Commissary and Exchange Service (EO 76)
11. Small farmers (RA 7607)	11. Overseas shipping industry (RA 7471)	11. Energy programme (EO 1075)	11. Asian Development Bank (EO 161)
12. Farmers in Virginia tobacco producing provinces (RA 7171)	12. Subic Economic Zone (EO 97)	12. Crude oil processing (EO 280)	12. Sequestered assets Disposition Authority (EO 286)
			13. Fertilizer and Pesticide Authority

Government assistance to special sectors is also guaranteed through fiscal privileges. Rural banks, cooperatives, the shipping industry, countryside and barangay establishments, firms locating in Subic Economic Zone, labour unions, and the iron and steel industry, have been virtually freed from taxation. The promotion of special sectors weakens the effectiveness of formulating a National Investment Priorities Plan (IPP) which lists priority areas deserving of government support. Special laws provide an avenue for providing subsidies to sectors which are considered less important than those in the IPP.

The most undesirable feature of special incentive laws is the promotion of interest groups who enjoy political patronage. Although there may be justifiable reasons for their fiscal privileges, there are equally strong reasons why they should not be granted. Special tax incentive laws create inequities in tax burden distribution because segments of society are allowed to be free-riders. They also create tax shelters and opportunities for tax avoidance in favour of the affluent and the powerful. The lack of a level playing field weakens competition, distorts pricing and resource allocation.

In the Philippine case, tax incentives have been extended to corporations such as the Manila Jockey Club (horse racing), Philippine Sports Commission, Philippine Telegraph and Telephone Corporation, People's Television Network Inc., and a host of other organizations. Preferred persons include inventors, returning Filipino residents, small farmers, veterans, artists, tobacco growers, among others. Their tax privileges also differ. There are those who are granted income tax holidays up to ten years, which is even more generous than the income tax protection of BOI firms. Some are luckier as their protection includes exemption from fees and charges. The most blessed ones are those which receive government appropriations upfront, such as provinces growing Virginia tobacco which receive 15 per cent of cigarette tax collection.

Foregone revenues from tax incentives totalled P 30.4 billion in 1992 with BOI firms accounting for 53 per cent. Such a magnitude dwarfs the P 20.6 billion deficit which the national government incurred in 1993. Given alternative uses of resources, could the economy be better off without the incentives and without such large deficit?

One final point with respect to tax incentives is the resulting complications of tax laws and their administration. Complicated tax laws tend to be unproductive, inequitable and inefficient. The tax base is heavily eroded leaving very little alternative for government except to control expenditures or increase rates. Taxpayers who are within the tax net pay the price resulting from the grant of incentives. The following statement made in a different context, succinctly summarizes the features that the Philippine tax system have acquired.

> Over the years, our tax system has become a crazy quilt of special incentives, special deductions and special write-offs. Each incentive gives a break to someone. But each special tax break means that taxes have to be higher for everyone else. Special breaks have made the income tax more and more complicated, and less and less fair.[10]

[10] From a statement made by the Canadian Minister of Finance in defence of that country's 1987 tax reform programme.

Tax policy and equity

The Philippine standard for an equitable tax system is a progressive distribution of the tax burden in accordance with ability to pay. This norm is entrenched in the Philippine Constitution which provides that "the rule of taxation shall be uniform and equitable."

Yoingco, Guevara and Gracia estimated the distribution of the tax burden using 1990 data and came up with a conclusion that on the whole, the total tax burden is progressively distributed except for an isolated aberration in the lowest income bracket (table 7). On the average, each household paid 19 per cent of its income in taxes in 1990. The distribution of the tax burden is regressive at the end of the income scale but becomes progressive thereafter. The tax burden rises as income increases and the highest burden of 30.44 per cent is shouldered by households in the topmost income bracket. The regressivity at the tail end is mainly caused by the regressivity of the indirect tax system. The very poor paid almost 12 per cent of their income on indirect taxes. If the tax system were only composed of direct taxes, the very poor would have only paid 1.0 per cent of their income as tax. In reality however, the country raised 66 per cent of its tax revenues from indirect taxes in 1990.

In terms of specific instruments, the progressive ones are the individual income tax, the corporate tax, the gift taxes, customs duties, and certain excise taxes.

The individual income tax is a progressive tax with the tax burden rising as income rises (table 8). Poor families are virtually exempt from the tax because of the provision for personal and additional exemptions. Under the present law, a married taxpayer with four dependents with an annual income of P 56,000 (US$ 2,026) is totally exempt from the income tax.

The burden of the corporate tax is also progressively distributed with the highest burden on families earning over P 130,000 (over US$ 4,727) who pay 10.99 per cent of their income as corporate tax.

Table 7. Ratio of tax paid to family income, by income class, 1990
(In per cent)

Income class (in pesos)	*Total tax burden*	*Direct tax burden*	*Indirect tax burden*
Total	18.94	7.68	11.25
Under 8 000	12.69	0.86	11.83
8 000 – 12 999	10.67	0.94	9.74
13 000 – 19 999	11.09	1.37	9.76
20 000 – 26 999	11.46	1.29	10.18
27 000 – 39 999	12.11	1.50	10.61
40 000 – 54 999	13.92	2.50	11.41
55 000 – 79 000	14.23	2.92	11.31
80 000 – 129 000	18.72	7.26	11.46
Over 130 000	30.44	18.60	11.83

Source: Yoingco, Guevara and Gracia, "A Study on the incidence of the Philippine fiscal system" (Manila, December 1992).

Table 8. Ratio of tax paid to family income, by type of tax and by income class, 1990 (In per cent)

Income class (in pesos)	*Industrial incorporation tax*	*Corporation incorporation tax*	*VAT*	*Customs duties*	*Petroleum products*	*Alcohol and tobacco*
Total	2.96	4.45	2.62	3.90	1.76	2.20
Under 8 000	0.03	0.83	3.45	2.65	1.00	3.18
8 000 – 12 999	0.03	0.91	2.52	2.34	0.89	3.03
13 000 – 19 999	0.10	1.27	2.59	2.42	0.93	3.05
20 000 – 26 999	0.03	1.25	2.65	2.66	1.00	3.18
27 000 – 39 999	0.05	1.45	2.73	3.12	1.05	3.10
40 000 – 54 999	0.15	2.35	2.83	3.92	1.10	2.92
55 000 – 79 000	0.91	1.95	2.83	4.16	1.20	2.40
80 000 – 129 000	4.09	2.50	2.78	4.73	1.26	1.97
Over 130 000	7.20	10.99	2.23	4.09	3.39	1.14

Source: Yoingco, Guevara and Gracia, "A Study on the incidence of the Philippine fiscal system" (Manila, December 1992).

The value-added tax cuts income of households by almost 2.62 per cent on the average and behaves as a proportional tax. Except for families from the highest income scale, the burden of the VAT rises progressively although the rise in the effective tax rates (ETRs) is quite marginal. The failure of the VAT to capture incomes of the affluent is accounted for by the exclusion of many activities from the VAT and leakages in its administration.

Surprisingly, customs duties behave progressively. On the average, customs duties reduce income by 3.90 per cent. The ETR on the poorest families is 2.65 per cent and increases to a maximum of 4.09 per cent on families from the highest income bracket. The rationalization of the tariff structure as well as the improved valuation system could have contributed to the progressive distribution of the duty burden.

Excise taxes on petroleum products are also progressive except that such progressivity does not include families at the tailend of the income scale. The ETR on poorest families starts at 0.97 per cent and declines to 0.87 per cent on the next income scale. From thereon, it rises continuously to a high of 3.29 per cent on the highest income group. The progressivity of the tax on petroleum products could have been brought about by the use of lower tax rates on products which are consumed by the poor. Diesel oil which is used in public transport is lightly taxed. The concept of a subsidized tax scheme is further enhanced by freeing LPG, a fuel commonly used by rural households, from taxation. Surveys on family expenditures also indicate that consumption of petroleum products varies directly with income.

Taxes on alcoholic products and tobacco are regressive and bear more heavily on the poor. For alcoholic beverages, the tax on the poorest income class of 1.56 per cent is greater than the average tax burden of 0.93 per cent. The regressivity of the tax is observed throughout the entire income scale as the ETR continuously declines as income rises. This pattern of taxation follows the expenditure of households on alcoholic products. Poorer families spend a higher percentage of their income on alcoholic products (1.6 per cent for lowest income families as contrasted to 0.8 per cent for families in the top income scale).

The excise tax on tobacco behaves similarly as the tax on alcohol. It is regressive with respect to income. The tax reduces income by 1.25 per cent on the average but the reduction suffered by poorer families at 1.62 per cent is greater than the average. The ETR tapers off to a low of 0.57 per cent for households in the topmost income bracket. The regressivity of the tax follows the general pattern of expenditures on tobacco. About 1.9 per cent of the expenditures of the lowest income families are on tobacco products.

In sum, the tax system appears to improve income distribution with an improvement in the Gini ratio from 0.45 to 0.34 before and after the imposition of taxes.

The most pointed criticism of the Philippine tax system is the horizontal inequity arising from differences in tax treatment of different forms of incomes. As earlier discussed, the Philippines follows a schedular approach to income taxation. With different bases and tax rate schedules, wage-earners bear a heavier burden relative to taxpayers with business incomes. For households earning over P 130,000, fixed income earners paid 14.40 per cent of their income as tax in 1990 compared to only 2.21 per cent paid by business income earners.

Deeper dimensions of inequity are brought into the fore by the non-uniform taxation of passive incomes. The exemption of dividends from taxation imposes a heavier tax burden on taxpayers with interest incomes and royalties, since they bear a 20 per cent final tax on gross. Taxpayers with capital gains are also favoured with the recent income tax exemption of capital gains from stock transactions . The presumptive approach to the taxation of capital gains from the sale of real property does not also contribute to effective taxation of those with greater ability to pay.

In theory and in practice, there are inherent weaknesses of the schedular approach to taxation. It does not allow an aggregation of all incomes of a taxpayer which is the best indicator of his total ability to pay. With the use of different tax rate schedules, additional incomes of taxpayers are not taxed at progressive rates. Instead the taxation of each type of income starts with low marginal rates.

But there are constraints which prevent government from going global in income taxation. The problems which prodded the shift to schedular taxation in 1981 have not been adequately addressed. Evasion of the individual income tax remains a serious problem with estimates increasing from P 10.0 billion in 1986[11] to P 40.4 billion in 1991.[12] Deductions have yet to be tamed and the levels of tax compliance and honesty in tax administration are far from satisfactory. Without a functional computerization programme, it would be naive to presume that taxpayers would voluntarily declare their correct incomes. There are equity and efficiency losses with the schedular approach but there is no certainty that these losses could be offset by a global approach. In the short-run, there may be a net gain in preferring a progressive schedular income tax system over a progressive global taxation which is beset with problems of tax avoidance and evasion. This choice is bolstered by surveys on recent tax reforms which noted lesser preoccupation of governments with

[11] National Tax Research Center, *A Study on Philippines Tax Administration* (1987).

[12] Rosario G. Manasan, "Breaking away from the fiscal bind: Reforming the fiscal system" (Philippine Institute for Development Studies, August 1993).

the global approach.[13] Even in industrial economies like Japan, passive incomes are taxed separately with a flat rate which is a *de facto* schedular income tax system. The Philippines may prove to be on the "cutting edge of the new wave of tax reform in developing economies".

The redistribution function of tax policy is completed through the expenditure programme of government. Ideally, a progressive tax system should be complemented with a regressive expenditure programme where benefits received as a share of income decreases as family income rises.

The fiscal incidence study of Yoingco, Guevara, and Gracia reported a regressive distribution of the benefits from the public expenditure programme. The ratio of benefits received from government expenditures to income or the EBR on the poorest families was about 154 per cent as contrasted to only 5.02 per cent on families with the highest income. The increase in income of households in the second income bracket was 75.32 per cent and the EBRs gradually decrease as income rises. There are caveats however in appreciating the impact of the budget on income redistribution. For one, the regressivity is not well pronounced since the differences in EBRs among income classes are marginal. One notable exception is the delivery of health services where a significant impact on the poorest households was observed. One way of looking at it is that budgetary outlays on health represent an increase in their income by 47 per cent. Another caveat is that the incomes of certain households are so low that even a 154 per cent increase in income due to government expenditures does not significantly improve welfare. In addition, since many of the benefits from public expenditures are collective in nature, they are hardly visible and felt.

After netting out the tax burden and transfers from the budget, Yoingco, Guevara and Gracia concluded that the poor emerged as "beneficiaries" and the families from the seventh to the ninth income classes as "contributors" to the fiscal system. The regressivity of the tax system on the poorest families is therefore redressed by the benefits that they receive from government services. Their net benefit was estimated at P 8,586 which represented a 139 per cent increase in their income. The burden of financing the fiscal system is on families with the highest income. Their net burden equals P 64,979 on a per household basis which means a 27 per cent reduction of their gross income (table 9).

The study identified social welfare expenditures as having the most visible effect on income redistribution. They are biased towards the poor since almost 72 per cent of the budget for social welfare went to households within the three lowest income classes. Other expenditure items such as those on agriculture, labour and employment, health and agrarian reform went to programmes which are taken advantage of by middle income families. Middle income families have an easier access to public services since public hospitals and training centres are located in urban areas. They are also better informed of the availability of public services and the personal benefits which their families may derive from such services. Poor families virtually spend all their time trying to make a living which deprives them of any opportunity to do something else.

[13] Vito Tanzi, "Tax reforms in industrial economies and the impact of the US tax reform Act of 1986" (International Monetary Fund, September 1987).

Table 9. Change in per capita income resulting from the tax-expenditure benefit process, 1990
(Amount in pesos)

Income class (in pesos)	*Income before tax*	*Net incidence*
Under 8 000	6 167	8 586
8 000 – 12 999	11 005	6 910
13 000 – 19 999	16 922	6 405
20 000 – 26 999	23 290	6 445
27 000 – 39 999	32 840	5 202
40 000 – 54 999	46 261	1 969
55 000 – 79 000	65 000	(752)
80 000 – 129 000	100 517	(10 801)
Over 130 000	238 797	(64 979)

Source: Yoingco, Guevara and Gracia, "A Study on the incidence of the Philippine fiscal system" (Manila, December 1992).

In terms of magnitude, expenditures on social services which benefit the poor such as education and health account for a significant part of the budget. Net of debt service, social services received the biggest budgetary allocation in 1993 of P 70.4 billion (US 2.56 billion) accounting for 21.3 per cent of the total expenditure program. This has been the trend starting 1987 when government accorded the highest priority on social services (table 10). The budget for health and education had significant growth rates starting 1988.

Education is accorded the highest budgetary allocation as mandated in the Constitution. This went as high as 17 per cent in 1990 representing 3.30 per cent of GNP. Investments in public health have been sustained accounting for about 0.80 per cent of GNP. The provision for socialized housing started thinning out in 1987 and needs to be invigorated.

IV. SUMMARY OF FINDINGS AND CONCLUSIONS

The Philippine tax system has been unable to generate adequate revenue to finance the expenditure programme of the Government. This has resulted in huge deficit of the national government peaking at P 37.2 billion or 3.5 per cent of GNP in 1990. The deficit fueled inflation which reached a record high of 47.1 per cent in 1984. Interest rate also surged to 30.5 per cent in 1984. High rates of inflation and interest mostly hurt the poor in terms of falling real wages and rising underemployment.

Major structural reforms which were introduced by the government starting 1986 improved tax performance. The 1993 tax effort of 15.3 per cent is a substantial improvement over the 12.68 per cent level in 1980. The tax system also became more buoyant with tax buoyancy estimates increasing from 0.85 per cent in 1986 to 1.36 per cent in 1992.

The major tax reforms introduced by government broadened the tax base, simplified the tax system and improved its equity and efficiency.

Table 10. Percentage distribution of national government expenditure by sector

	1984	*1985*	*1986*	*1987*	*1988*	*1989*	*1990*	*1991*	*1992*
Total	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00
Economic services	30.67	23.16	24.55	16.16	15.59	22.80	22.08	25.29	19.52
Agriculture, agrarian reform, and natural resources	5.24	5.42	4.50	4.82	5.03	7.48	7.94	8.45	5.05
Trade and industry	1.06	1.11	0.53	0.65	0.53	0.70	0.56	0.65	0.45
Tourism	0.16	0.17	0.12	0.10	0.15	0.15	0.12	0.21	0.12
Power and energy	1.31	1.54	1.19	1.15	0.13	0.57	1.06	0.92	0.66
Water resource development and flood control	1.00	1.68	1.39	0.09	0.84	1.15	1.80	1.95	1.36
Communications, roads and other transportation	10.77	10.39	7.90	5.93	7.73	9.76	8.04	7.65	9.02
Other economic services	11.13	2.85	8.92	2.61	1.16	2.99	3.97	5.46	2.85
Social services	17.68	17.48	18.35	17.74	18.55	22.22	26.51	24.57	20.54
Education, culture and manpower development	11.65	12.27	12.96	11.00	13.15	15.79	16.79	15.50	13.15
Health	3.34	3.56	3.12	2.64	3.32	3.74	4.07	3.99	3.46
Social security, welfare and employment	0.93	0.85	0.72	0.65	0.69	0.91	1.63	1.35	1.19
Housing and community development	1.72	0.77	1.35	0.29	0.36	0.36	0.32	0.63	0.11
Other social services	0.04	0.03	0.20	3.17	1.04	1.41	3.69	3.10	2.63
Defense	11.36	11.52	10.12	8.10	10.93	11.40	11.01	10.22	9.33
Domestic security	7.86	8.16	6.65	5.44	7.38	7.53	6.90	6.67	6.04
Peace and order	3.51	3.36	3.47	2.65	3.55	3.87	4.12	3.56	3.29
General public services	11.98	12.04	9.31	8.10	9.40	10.07	10.46	10.21	11.74
General administration	5.70	6.02	4.85	4.04	4.66	5.90	5.73	5.85	7.33
Public order and safety	1.28	1.28	1.14	1.01	1.17	1.54	1.57	1.53	1.72
Other general public services	5.00	4.74	3.33	3.05	3.57	2.62	3.16	2.84	2.69
Net lending	6.45	14.34	13.16	4.93	2.93	0.92	(0.22)	0.31	0.77
Debt service fund	21.85	21.46	24.51	44.97	42.60	32.59	28.75	29.39	38.11
Interest payments	15.17	16.77	18.87	23.81	27.40	22.67	20.84	20.43	27.76
Debt amortization	6.69	4.69	5.63	21.16	15.21	9.93	7.91	8.96	10.35

Source: Department of Budget and Management.

Improvements in tax enforcement were effected through an expanded withholding system, control in the filing of returns and payment of taxes of large taxpayers, increase in the penalties for tax evasion, and raffle of invoices.

A comprehensive computerization program is expected to improve data base development and the monitoring of tax payments. In preparation for the computerization of tax collection, systems and procedures have been simplified and a tax identification number (TIN) system for taxpayers has been prescribed.

The BIR has also been reorganized leading towards decentralization of functions, streamlining of operations, and accountability.

Despite improvements in tax performance, chronic problems of the tax system remain. These are the erosion of the tax base through the continuous grant of tax incentives and abuses in deductions. There are also leakages in the tax system which allow taxpayers to undervalue the tax base.

Tax administration is hamstrung by the absence of a functional Management Information System, the lack of a systematic audit programme, and problems of graft and corruption.

Reforms are needed to fine tune the fiscal incentive system with the needs of the economy. In particular, the BOI incentive system is biased towards capital intensive industries and does not promote the creation of more employment opportunities. Small and medium enterprises in the countryside have had very little access to the BOI incentive system. Special incentive laws work against an equitable distribution of the tax burden, weaken competition and distort resource allocation. They also complicate tax administration.

On the whole, the burden of Philippine taxes is progressively distributed except for an isolated aberration in the lowest income bracket. The regressivity at the tailend is mainly caused by the regressivity of the indirect tax system. The very poor paid almost 12 per cent of their income on indirect taxes. If the tax system were solely composed of direct taxes, the very poor would have only paid 1.0 per cent of their income as tax.

One of the most pointed criticism against the equity of the Philippine tax system is the horizontal inequity arising from differences in tax treatment of different forms of incomes. The Philippines uses a schedular approach which in theory is inferior to the global approach in evolving a progressive system of income taxation.

Constraints prevent government from going global in income taxation in the short-run. The problems which prodded the shift to schedular taxation in 1981 have not been adequately addressed. Evasion remains a serious problem, a functional computerization programme is yet to be developed, and levels of tax compliance and honesty in tax administration are far from satisfactory. A shift to global taxation is premised on a scenario where the minimum requirements for an efficient income tax system are in place.

A Comprehensive Tax and Tariff Reform Programme must be formulated. The alleviation of poverty necessitates growth. Growth creates more employment opportunities and higher incomes. Growth is supported by the provision of adequate infrastructure and services. Their financing is the primary responsibility of the tax system.

To strengthen the capability of the tax system to finance long-term requirements of growth, inefficiencies and inequities in the system must be eliminated. This is not possible with a patchwork approach to tax reform. It calls for a comprehensive tax and tariff reform programme. The programme must put in place broad bases for all taxes which makes possible the imposition of low tax rates. It must install a simple tax system which is free from distortions and opportunities for the use of discretion.

In the area of individual income taxation, the feasibility of using a uniform tax rate schedule for all forms of incomes should be studied.

For corporate income taxation, the use of a modified gross income tax approach should be pursued. This means using a broad income tax base through the disallowance of deductions which are easily subject to abuse. The feasibility of imposing a minimum corporate tax based on assets or net worth is an option worth considering.

The VAT reform should focus on the immediate improvement of its administration, particularly on the following: 1) education of traders and a massive information drive; 2) the development of a comprehensive tax roll; 3) the installation of systems to track sales subject to VAT; 4) crosschecking of claims for credit and refund; and, 5) the training of examiners on VAT audit.

The reform of the incentive system should consider that a regime of low tax rates weakens the need for preferential tax treatment. Thus, the phasing-out of tax incentives can be supported. As safety nets, basic incentives such as the provision for firms to carry forward their losses and the use of accelerated depreciation can be universalized.

Tariffs should also be restructured to eliminate distortions against major sectors such as agriculture and exports. It is most ideal for government to move towards a one tariff band. It is efficient and will eliminate incentives for smuggling and the pressure to obtain duty exemptions. It will also do away with the need to maintain a huge bureaucracy in tariff administration.

The coddling of tax evaders in the past deprived government of significant revenues. It eroded the confidence of the public on the capability of government to enforce the tax laws objectively. There is also an equity dimension in tax evasion because evaders robbed the community of an opportunity for an improved quality of life.

Tax administration should continuously be improved. There is so much inefficiency in tax administration. There are no mechanisms whereby the BIR can systematically identify and analyse problem areas in tax administration. Attempts to analyse trends in collection and spot check irregularities have been sporadic. Systematic techniques and procedures to permit efficiency in tax collection are not in place. There are no complete data on the tax base and no existing systems to monitor and crosscheck tax payments.

Highest priority should be given to the development of a high level of integrity and honesty among BIR officials and employees. A genuine and courageous effort must be waged to purge those who enriched themselves in office.

A functional data base should be established. This means developing a comprehensive tax roll of all individuals and corporate taxpayers. This can be facilitated with the help of local governments, other government agencies, and the private sector.

Standards should be set to guide BIR in the conduct of tax audit and investigation. The lack of standards not only introduces discretion into the system but dissipates administrative efforts which could have been focused on cases which yield high revenues.

THAILAND

I. PROFILE OF THE TAX SYSTEM

The structure of tax revenue

As is typical in developing countries, indirect taxes have played a pivotal role in providing government revenue in Thailand. Around three fourths of tax revenue have been generated from indirect taxes. However, there has been a decline in recent years in the share of indirect taxes with a corresponding rise in the share of direct taxes in revenue. Thus the share of indirect taxes in total tax revenue decreased from as high as 79.6 per cent in 1980 to 68.8 per cent in 1992. On the other hand, the share of direct taxes increased from 20.4 per cent in 1980 to 31.2 per cent in 1992 (table 1).

Taxes on domestic goods and services comprising the business tax (replaced by value added tax in 1992) and the excise tax followed by import duties have played the leading role in indirect tax collections. (A full description of the structure of the tax system is given in the annex to this paper). International trade taxes, however, played a lesser role in terms of their contribution to government revenue compared to their role in many developing countries and their role have tended to decline further in Thailand in recent years, as the taxes on exports have virtually been eliminated and import duties are being rationalized and reduce in the context of an increasing liberalization of the trade regime. Thus tax on domestic goods in the form of the business tax/value added tax and the excise contributed on average 51.7 per cent of total tax revenue during 1986-1988. Though this share tended to decline subsequently, accounting for only 48 per cent of total tax revenue in 1992 reflecting a rise in relative share of direct tax in total revenue, taxes on domestic goods, nevertheless, remained the largest source of government revenue. The share of tax revenue from international trade taxes has shown a sharp decline from 24.6 per cent average during 1989-1991 to 19.2 per cent in 1992 (table 2).

During 1980-1982, income taxes, comprising the personal income and company income taxes, contributed only 22.5 per cent of tax revenue. Their shares increased markedly to 26.3 per cent in 1989-1991 and further to 31.1 per cent in 1992 due to a rapid increase in corporate

Table 1. Share of direct and indirect taxes in total tax revenue (Value in million baht)

Fiscal year	*1980*		*1983*		*1986*		*1988*		*1990*		*1992*	
	Amount	*Per cent*	*Amount*	*Per cent*	*Amount*	*Per cent*	*Amount*	*Per cent*	*Amount*	*Per cent*	*Amount*	*Per cent*
Tax revenue of which	82 337.9	100.0	120 339.9	100.0	146 260.9	100.0	224 936.5	100.0	359 226.0	100.0	448 318.4	100.0
Direct tax	16 761.5	20.4	27 283.8	22.7	35 819.8	24.5	51 616.1	22.9	100 584.8	28.0	139 938.7	31.2
Indirect tax	65 576.4	79.6	93 056.1	77.3	110 441.1	75.5	173 320.4	77.1	258 641.2	72.0	308 379.7	68.8

Table 2. Revenue share of individual taxes
(Percentage)

	1980-1982	*1983-1985*	*1986-1988*	*1989-1991*	*1992*
Tax revenue	100.0	100.0	100.0	100.0	100.0
Income tax	22.5	23.9	23.0	26.3	31.1
Personal income tax	9.7	12.9	11.8	10.6	11.5
Corporate income tax	12.8	11.1	11.0	14.7	19.3
Taxes on domestic goods	47.3	49.0	51.7	46.9	48.0
Business tax	21.8	21.7	22.3	24.3	8.4
Value-added tax and specific business tax	...	...	...	...	...
Excise tax	25.5	27.4	31.6	22.6	22.6
International trade taxes	25.0	23.8	22.8	24.6	19.2
Import duty	21.9	22.3	22.3	24.5	19.0
Export duty	3.1	1.5	0.4	0.1	0.0
Other taxes	5.2	3.3	2.6	2.1	0.3

income tax revenue which comprised 14.7 per cent of revenue in 1989-1991 and 19.3 per cent in 1992. The rise in corporate income tax revenue during this period reflected the very high rates of growth in the economy. An influx of foreign investment into the economy and substantial increase in economic activities contributed to the buoyancy of corporate income tax. Personal income tax revenue did not however show any advance as recent reforms increased allowances and deductions and reduced rates of individual tax.

Since 1980, the rate of growth in tax revenue has generally exceeded the rate of growth in GDP. As a result, revenue buoyancy greater than one has been recorded and the tax-GDP ratios gradually increased from 12.5 per cent in 1980 to above 17 per cent in 1991/92. Tax revenue displayed greater buoyancy during the later part of the 1980s (table 3). Buoyancy values for total tax revenues along with those of domestic taxes increased considerably while those of foreign trade taxes sharply declined. That was indicative of the decline in the revenue importance of foreign trade taxes. Buoyancy values of most taxes increased. While those of international trade taxes declined specially after 1987. This reflected the fact that tax reform measures embarked upon after 1987 aimed at relying more on domestic taxes.

It is also noticeable that during the period of 1987-1990, growth rates of tax revenue are significantly higher, ranging from 20 to 28 per cent reflecting the buoyancy of the economy (table 4). Revenue growth slowed in 1992, partly reflecting the switchover to the value added tax replacing the old business tax. The growth rate of government expenditure also accelerate since 1989 as the government resorted to spending more on the social sectors and invested more in various infrastructural projects. Nevertheless, government budget started showing a surplus since 1989. During 1980 through 1988, GE/GDP ratio exceeded the tax/GDP ratio. Thus the Government ran budget deficit throughout as it attempted to rehabilitate or stimulate the economy after the second oil crisis (1979/80). The surpluses that accrued since 1983 reflected a vast improvement in revenue collection and overall fiscal management.

Table 3. Tax-GDP ratio and tax buoyancy

Year	Tax/GDP (percentage)	Tax buoyancy (total)	Tax buoyancy[a]					
			Personal income tax	Corporate income tax	Business tax	Excise tax	Export tax	Import tax
1980	12.5	1.30	0.99	1.33	1.04	2.07	1.52	0.85
1981	12.6	1.07	1.21	2.43	1.23	1.16	–0.65	0.90
1982	12.2	0.59	4.06	0.06	0.79	2.08	–5.44	–1.09
1983	13.2	1.81	2.31	0.01	1.10	2.89	2.04	2.81
1984	13.5	1.33	2.77	1.41	2.76	–1.39	–0.07	2.71
1985	13.9	1.88	3.96	1.63	0.72	3.95	–9.32	0.01
1986	13.3	0.36	0.04	0.03	–0.84	2.64	–6.77	–0.16
1987	14.1	1.46	–0.08	1.18	1.35	2.19	8.11	1.74
1988	14.9	1.37	1.12	2.43	2.05	0.24	–0.59	2.26
1989	15.7	1.36	0.98	2.26	1.97	0.68	–2.92	1.36
1990	17.5	1.84	2.53	3.52	2.28	0.13	–5.76	1.96
1991	17.9	1.21	1.67	1.87	1.41	1.79	–5.24	0.16
1992	17.1	0.52	0.71	1.42	–5.61	0.89	–1.34	–0.65
1980-1993[b]	...	1.29	1.35	1.62	1.07	1.15	–4.08	1.29

[a] Summary of buoyancy values for individual taxes.
[b] Buoyancies obtained from natural logarithmic regression using.

Table 4. Tax revenue and government expenditure

Fiscal year	Tax revenue (million baht)	Percentage change	Expenditure (million baht)	Percentage change	Tax/GDP (per cent)	GE/GDP (per cent)
1980	82 337.9	23.10	10 900.0	–	12.5	16.5
1981	95 927.7	16.50	140 000.0	28.40	12.6	18.4
1982	100 393.2	4.60	161 000.0	15.00	12.2	19.6
1983	120 339.9	19.87	177 000.0	9.94	13.2	19.4
1984	131 508.5	9.28	192 000.0	8.47	13.5	19.7
1985	141 922.8	7.92	213 000.0	10.93	13.9	20.9
1986	146 260.9	3.06	218 000.0	2.35	13.3	19.8
1987	176 141.7	20.43	227 500.0	4.36	14.1	18.1
1988	224 936.5	27.70	243 500.0	7.03	14.9	16.2
1989	279 591.3	24.30	285 500.0	17.20	15.7	16.1
1990	359 226.0	28.48	336 507.6	17.87	17.5	16.4
1991	422 996.9	17.75	387 500.0	15.15	17.9	16.5
1992	448 318.4	5.98	460 400.0	18.80	17.1	17.6

Deficiencies of the tax system

Five points of shortcomings of the current Thai tax system can be pinpointed as follows:

Too high tax rates

Rates of income as well as other taxes in Thailand have been relatively high. High tax rates create an incentive to avoid paying taxes. Tax avoidance can be of two forms: legal and illegal. Taxpayers can avoid paying taxes legally through bargaining for preferential rates, or

lobbying politicians or the government to enact laws that exempt their incomes or activities from tax bases such as the Investment Promotion Act. Tax evasion *per se* is illegal and is encouraged if tax rates are too high. Legal and illegal tax avoidance destroys the neutrality of the tax system and impinges upon government revenue.

Excessive protection to domestic industries

In the past, the main economic strategy of the Government was to support import-substituting industrialization. To meet the objective, the tax system was designed to protect domestic industries against foreign competition. Protected firms had no incentives to improve their efficiency and productivity resulting in high-cost products. In recent years, the world economy has changed very rapidly and so has the development policy regime. Most countries experienced deficiencies of import-substitution policy and switched to support the popular export-led growth regime. Such a regime places emphasis on alleviation or elimination of tariff and non-tariff trade barriers with a view to liberalizing international trade and investment.

Narrow tax base

Statistics has shown that taxable income accounted for only 19.9 per cent of national income and taxable value of imports amounted to just 54.9 per cent of total import value leaving a large part of the taxable bases untouched. Scores of tax exemptions and exclusions and prevalent tax avoidance and evasion are normally mentioned as the cause of narrow tax base.

Multiplicity of tax rates

Under the tariff schedule there are still 39 different rates of import duties ranging from 0 to 100 per cent. Under the excise tax, there are 45 different tax rates: specific and ad valorem. Too many tax rates distort the resource allocation pattern, create administrative difficulties, and provide leeway for tax officers to be corrupt.

Targeting to achieve multiplicity of objectives

Tax policy has been targeted to fulfill at least five objectives, namely government revenue collection, equitable income distribution, economic stabilization, economic growth, and efficient resource allocation. Thus, tax policy has been utilized to fulfill too many objectives resulting in more distortions and failure to meet the set target. Furthermore, some taxes are not implemented consistent with their main function. For instance, import duty is appropriate for giving protection to domestic industries but it is also utilized to curtail consumption. That function should instead be assigned to the excise tax.

II. EXPERIENCE IN TAX SYSTEM REFORMS

During the last thirty years starting from 1961, which was the first year of the First National Economic and Social Development Plan, the crucial objective of economic development has been to give the private sector a driving role while the Government playing a supportive role in the economy. The Government played the role as facilitator and regulator to enhance the performance of the private sector driven economy. Thailand has passed successfully through numerous waves of internal and external disturbances partly owing to

the fact that the Government carried out appropriate reform and adjustments in tax policy. Many elements of the deficiencies of the system persisted requiring further reforms to enable Thailand fit itself well into the new competitive environment emerging in the 1990s. Experiences of tax system reform starting in 1961 when the First National Economic and Social Development Plan was launched.

Reforms during 1961-1986

The results of economic development during the First (1961-1966) and Second (1967-1971) National Economic and Social Development Plans were satisfactory as shown by high average economic growth rates of 8 and 7.5 per cent, respectively. Notwithstanding this positive achievements, there were problems that intensified during the Third National Economic and Social Development Plan (1972-1976). During this period, the oil crisis (1973/74) put pressure on the Government to aim fiscal policy towards lowering or containing inflation at a sustainable level. Measures implemented were mostly tax measures, such as lowering excise taxes on some essential products, increasing excise taxes on luxury products and on gasoline, and decreasing import duties on raw materials and machinery to lower production costs thereby promoting domestic production, and enhancing competitiveness of Thai exports.

During the Fourth (1977-1981) and Fifth (1982-1986) National Economic and Social Development Plans, the Government had to face both internal and external disturbances causing economic instability. The shock started off with the second oil crisis (1979/80), which led most countries to employ restrictive and stringent fiscal and monetary policies. As a result, the global economy plunged into a recession with severe repercussion on the Thai economy. Thai exports dipped, trade deficit was high, and the current account deficit in 1981 ran at 7.4 per cent of GDP. The inflation rate shot up to 12.7 per cent. Since 1982, the industrialized countries also attempted to revive their economies and fight high unemployment by using restrictive trade practices. In the process Thai export was adversely affected and the economy slided into a deep recession. Tax revenue collection, as a consequence, slumped during 1981 to 1986, giving rise to a high average budget deficit of 4 per cent of GDP. Tax measures implemented during this period can be summarized as follows.

In 1981, reductions in various taxes were made so as to stimulate investment, production and export. These included, *inter alia,* a decrease in export duty on natural rubber, a reduction in royalties, a decrease in excise tax on gasoline, a reduction in corporate income tax, and income tax exemption on interest from foreign loans. At the same time, some tax increases were also effected to compensate revenue losses from tax reductions. These included, for example, corporate tax payment twice annually to facilitate a smooth stream of government revenue in each fiscal year, and increased excise taxes on beverages and cigarette.

During 1982-1984, the objective of tax measures was to improve fiscal position of the Government by reducing deficits. An increase in stamp fees, increase in import duties on some products, and an imposition of a travel tax were some of the measures implemented. Important reforms in individual and corporate income taxes, customs duties and the excise tax were made during 1985/86. These reforms aimed at increasing tax revenue and promoting Thai export. These reforms also aimed at increasing tax revenue and promoting exports. The economy responded positively to these measures and was aided further by the oil price decline

in 1986. Exports increasingly expanded while imports declined resulting in reduced trade deficit and the current account turning into a surplus. Inflation fell to its low level of 1.9 per cent. However, growth rate of the economy slowed down to 4.4 per cent during the Fifth National Economic and Social Development Plan.

Reforms since 1987

Tax policy since 1987 has been less restrictive and geared further towards stimulating the economy. The economy picked up to an average growth rate of 10.5 per cent during the Sixth National Economic and Social Development Plan (1987-1991). Government revenue expanded and collections exceeded estimates for the first time in 1987. The Government ran a surplus budget since 1988, the fiscal position during this period being the strongest in past thirty years. With a view to stimulating growth of the economy and to rectifying problems arising from huge current account deficit and high inflation rates, tax policy measures introduced during 1987-1991 can be described as follows.

In 1987, the Government embarked on a policy to promote the development of money and capital markets. Among the tax measures introduced were an exemption of the business tax and stamp fees on bonds issued by the Bank of Thailand and a reduction of income tax on dividend incomes, profits received from registered companies, mutual funds, and from financial institutions set up for the purpose of lending fund for promoting agriculture, commerce and industry. In addition, business taxes and import duties on tin and sugar were reduced. Export duty on natural rubber were reduced to promote natural rubber export.

Some tax measures implemented during 1988-1990, in addition to promoting production and exports, aimed at alleviating the high costs of living faced by the people. An exemption of individual income tax on interest on deposit lower than 200,000 baht, and a lowering of the burden of income taxpayers by reducing tax rates and increasing allowances were some of the measures directed to that end. A decrease in import duty on steel and an exemption of import duty and excise tax on cement to alleviate problems arising out of the shortage of the construction materials were other major tax changes.

The progress Thailand achieved over the years has significantly altered the economic structure of the country. Industrial output has now replaced agricultural output in terms of proportion to GDP. Modern sector has expanded as the economy has become more outward-looking and export oriented. To fine tune tax structure to suit the current situation may not be an answer as it could not solve the weaknesses inherent in the system. For that reason and with a strong treasury position, the Ministry of Finance has embarked upon a complete overhaul of the tax structure since 1991. The reforms are designed to comprehensively restructure and liberalize fiscal and financial regimes with a view to enabling the economy to better adjust to the changing global conditions. The underlying rationale behind these reforms are: to improve the competitiveness and the investment climate of the Thai economy by way of lowering the costs of production thereby enabling Thai industrial exports to better compete with other emerging economies in the Asia and Pacific region; to promote efficiency of production through neutral tax treatment and elimination of distortions and interference by the Government through tax measures allowing optimum choice by business entities on production processes, organizational structure and financial instrument thereby helping to improve the overall economic efficiency; to promote sound financial market development

and structure through providing neutral and equitable tax treatment of dividend income and interests so as to ensure flexibility of financial market and adjustment in accordance with market forces; to assure equitable and transparent tax treatment and tax compliance.

A series of reform measures has been systematically implemented. Within a short period of time, the following changes have been made:

The value-added tax has replaced the out-of-date business tax and excise taxes have been restructured to better conform with the general direction of tax policies; the personal income tax has been restructured by reducing the number of tax brackets, lowering the top tax rates, and increasing deductible allowances; the differences in tax rate levied on corporate income of listed and non-listed companies have been eliminated and regulations on treatment of assets and debts have been improved; withholding tax rate on dividends and profit remittance has been reduced and larger tax credits for income received from abroad have been granted; nuisance taxes such as the travel tax have been abolished; customs tariff reforms by lowering import duties on products of certain sectors starting with machinery, automobiles and parts have been initiated.

Tariff reforms which began in 1991 will be continued. This is to ensure competitiveness and to improve resource allocations. Customs duties on the remaining machinery and equipment, raw materials and semi-finished products would be reduced. Current plans aim at reducing the number of duty rates to 6 only in lieu of the current 39 different rates. This will be done after taking account of the obligations that Thailand has under the GATT/WTO and the ASEAN Free Trade Area (AFTA).

Some of the out-of-date taxes need to be either removed or replaced. Example are the stamp duty which is considered to be a nuisance tax, and specific business taxes. Other taxes which need to be reformed are local taxes, such as the house and rent tax and the land development tax. They should be merged to form a single property tax. Tax administration need to strengthened to improve tax compliance and to close the collection loopholes.

To recapitulate, recent tax reforms in Thailand, the following summary is provided:

1991 – Restructured personal income tax by

- reducing the number of tax brackets to 5
- increasing the size of brackets and deductible allowances
- reducing top marginal tax rate to 37 per cent
- reduced tax rate on corporate income of non-listed companies to the same level of 30 per cent as on listed companies
- began restructuring customs duties on machinery and computers, automobiles and parts
- abolished nuisance taxes such as the exit tax

1992 – Introduced value-added tax, replacing business tax

- rationalized taxes on income, dividends and interests to be neutral
- continued tariff reforms in the remaining sectors so that customs duties will only have 6 basic rates 0, 1, 5, 10, 20, 30 per cent

1993/94 – Continued with tariff reform

- reformed local government finance

Probable impact of the reform is expected to lower costs of production owing to lower import duties on capital goods, raw materials, semi-finished and finished products and by eliminating cascading effects of the business tax with the introduction of the VAT. Lowering of costs will put a downward pressure on the price level though demand stimulation resulting from a lowering of taxes can exert an upward pressure. On balance however, the price effect of tax reforms can be expected to be favourable.

Competitiveness of the Thai export in the world market will improve from a lowering of the cost of production, and the introduction of the VAT which can fully refund input tax to exporters in line with GATT principles. However, import tends to increase due to the fact that tariff rates are curtailed. This will put pressure on domestic producers to improve their efficiency since there will be more fierce competition from freer flow of foreign products. This, however, will benefit consumers in terms of having a broader selection of good quality products.

Finally, the reform is expected to alleviate income disparity. There are four reasons that lead to such a conclusion. First, relying less on import tariff entails positive effect on income distribution because import tariff *per se* is an indirect tax and considered to be regressive. Second, the burden of the tax on low and middle income families will be lesseed since tax rates and a number of tax brackets were reduced and deductible expenses as well as allowances were increased. Third, the replacement of the business tax with the VAT contributes to improved income distribution since the VAT is not imposed on agricultural products and exports while the business tax was levied on agricultural products exported. Lastly, the reform will broaden the tax base and establish fairer tax system so that there are increased number compliant taxpayers.

Reform in tax administration

As indicated before, tax reform will not be successful unless tax administration is strengthened. The reform of tax administration is therefore high on the agenda of the government. A brief overview of the tax administration of Thailand, its deficiencies, and appropriate measures to improve tax administration are highlighted below.

Organization of tax administration

In Thailand, there are three major departments in charge of collecting taxes: the Revenue Department, the Excise Department, and the Customs Department.

The Revenue Department collects revenue from taxes, such as the personal income tax, corporate income tax, value-added tax, specific business tax, petroleum income tax, and stamp duties. Major collections are from the income and value-added taxes which accounted for around 45 per cent of total tax revenue in the 1992 fiscal year. The Excise Department collects revenue from selective taxes on eleven products. Those taxed commodities are petroleum and petroleum products, beverages, tobacco, playing cards, spirits, vehicles, yachts, crystals, perfumes, chandeliers and lightings, and horse racing courses. It is the second major tax collecting agency. The Customs Department collects customs duties from the exportation and importation of tradeable goods and services. The Customs Department generates the least revenue among the three departments since the importance of customs as a source of revenue has declined.

Problems and remedies

Three major categories of problems for tax administration can be identified. These relate to administrative matters *per se*, taxpayers' attitude and education, and legislative and institutional problems. Lack of well-trained audit staff capable of understanding the complexities of taxable transactions and tax returns, and corruption among officials are major administrative problems.

Many people do not have the correct understanding of the importance of tax and deliberately seeks to avoid tax payment. Complicated tax structures confuse taxpayers' understanding of their duties and responsibilities. Many taxpayers do not have sufficient knowledge of tax laws and fail to file their tax return voluntarily. Frequent revisions of tax policies and tax laws also result in misunderstanding and confusion.

The remedial measures that suggest themselves may be summarized as follows. Tax laws and procedures should be simplified. The tax laws are usually of a complex in nature. That in itself encourages finding loopholes for tax avoidance. In the course of actual implementation, things may be further complicated or simplified from the taxpayers' point of view. From this point of view simplification and clarity of tax return forms that taxpayers are required to fill in and return to comply with tax laws can have a positive effect on tax compliance. Tax authorities should pay close attention to simplify tax return forms with unambiguous and easily understable instructions. Neither tax laws and regulations nor tax forms should be frequently changed.

Public relation work should be undertaken towards the end of taxpayer education. It is very crucial to enhance taxpayers' awareness of the importance of their duties. Studies on taxpayers' behaviour show that the level of taxpayers' voluntary compliance is closely related to the level of taxpayers' understanding of tax laws and administration. Therefore, publications and media coverage on tax matters in simple languages can help in these respects. Public relation campaigns should focus on improving taxpayer's confidence on the tax administration. With a view to providing tax education, T.V. and radio programmes on tax matters should be organized. In order to create taxpayers' compliance, the Government should make the taxpaying public know what is expected from them and what they are to do. The objective of educational programmes is to provide people with accurate and relevant information that is helpful and understandable.

Tax withholding at source simplifies tax administration in many ways. Withholding at the source of income decreases opportunities for non-compliance. It thus enhances taxpayers' voluntary compliance, creates a steady flow of revenue, and provides greater convenience for taxpayers through installment payments. In order to minimize tax evasion and avoidance, the scope for withholding tax can be extended to most categories of income that accrue under contractual relationships of any form e.g. from employees.

Extension of coverage of information collection is an essential necessity for effective administration. Along with the economic development, the transactions have rapidly increased in quantity and have become diversified and complex at many levels. Also, the device of tax evasion and avoidance has become more sophisticated. To catch up with these trends in the private sector, tax authorities should have adequate capacity to keep track on information on taxpayers' taxable transaction and should be able to control an monitor it. With a view to sharing information, the exchange of information between the tax collecting departments and other government agencies should be a routine process.

Computerization of tax administration will be of great help in this regard. The significance of computers in improving tax administration and controlling tax evasion and avoidance has remained undisputed. Recently, many corporations have been utilizing computers for accounting and record keeping with formats differing greatly from that of conventional manual system. To cope with the changing situation, it is a must to improve efficiency of tax administration through utilizing more computers. The computer system can easily perform the following routine work:

Select and print only needed data from a great mass of data; pull together data from fragmented invoices by searching a file for all identical invoice number; reframe records in conformity with auditing convenience; print tax notice and other guidance for taxpayers; make more sophisticated analysis of data.

The ultimate deterrent to non-compliance depends on effective enforcement effort by tax authorities. Tax authorities, therefore, should continue to put efforts to improve technology and skill to detect cases of tax evasion and avoidance. In addition, they should develop the methods of audit to be able to detect the sophisticated devices of tax evasion of taxpayers.

Some taxpayers fail to file tax returns and make mistakes through ignorance or neglect. These must be detected and corrected through the auditing process. A passive attitude by the authorities towards these errors and falsifications will soon undermine the credibility of tax administration. Tax administrators seeking taxpayers' compliance must also protect those who try to comply.

Taxpayer registration, if carefully prepared and matched against the returns, will reveal the failures of taxpayers to file tax form. It is often impossible for each return to be given intensive scrutiny. A programme of investigation and examination of returns therefore should be planned. Its objective should be an effective examination which both safeguards the Government from major losses and instills in taxpayers a respect for the vigilance of the authorities.

III. TAXATION, REDISTRIBUTION AND GROWTH

The period since 1980 to the present has been one of profound change in the Thai economy. Thailand, like all oil importing countries, suffered from the two oil shocks that took place in the 1970s. The effects lingered on in the early 1980s, with growth rates plummeting to record low levels and inflation surging to double-digit rates. However, the country went through this turbulence by employing conservative macroeconomic policies. Maintenance of financial prudence and implementation of structural adjustment programmes enabled the country to avoid the prolonged difficulties that many other developing countries suffered.

By the latter half of the decade, Thailand became one of the most rapidly growing economies in the world. Growth recorded double-digit rates for three years in a row from 1988-1990. This could be attributed to a number of favourable developments, the most important of which were the unprecedented boom in exports and investment. Exports of manufactured goods rose at a rate close to 30 per cent per year, which in turn fueled more investments rising at about 20 per cent per year in export-related industries.

A noteworthy feature of economic expansion is that it took place with little acceleration of inflation. The strains were, however, felt in the widening external deficit. Although private savings had risen, it lagged behind the extraordinary rise of private investment so that a current account deficit appeared. Therefore, the country had to rely to a large extent on sizeable inflows of foreign capital for financing domestic investments.

Relatively more unfavourable external factors in the 1990s have helped to stabilize the Thai economy to a more sustainable growth rate of 7-8 per cent. This is a welcome relief as it allows the authorities to put in place many decisive reforms, including financial liberalization measures and tax restructuring programmes, that will prepare the Thai economy well into the twenty first century.

Table 5. Summary of Thailand's economic performance, 1980-1993
(Percentage)

Year	*GDP[a] growth rate*	*Inflation rate*	*Saving rate*	*Investment rate*	*Exports growth rate*	*Imports growth rate*	*Current account balance[b]*
1980	...	19.7	18.7	25.2	...	...	...
1981	6.3	12.7	17.4	24.7	13.8	13.7	-7.4
1982	4.1	5.2	20.6	23.4	4.7	-10.5	-2.8
1983	7.3	3.8	16.8	24.0	-7.7	21.2	-7.3
1984	7.1	0.9	19.4	24.5	19.6	3.7	-5.1
1985	3.5	2.4	20.2	23.7	10.5	4.6	-4.1
1986	4.9	1.9	22.1	21.8	20.8	-3.0	0.5
1987	9.5	2.5	22.9	23.7	28.8	38.8	-0.8
1988	13.2	3.8	26.1	28.9	33.9	46.2	-2.7
1989	12.0	5.4	27.9	31.5	27.7	29.9	-3.7
1990	10.0	6.0	29.4	36.7	14.4	29.0	-8.9
1991	8.2	5.7	...	...	23.5	15.4	-8.1
1992	7.4	4.1	...	...	13.2	5.5	-6.4
1993	7.5	3.2	...	...	11.5	12.8	-6.4

[a] Growth rate at constant 1972 prices.
[b] As percentage of GDP.

Allocative effects of tax policy

The successful performance of the Thai economy has been due to many positive factors including, among others, improved world economic conditions, investment and export booms, and appropriate policy reforms. Tax policy, which is our focus, did not work in isolation; numerous variables were changing simultaneously. It is extremely difficult, if not impossible, to single out the pure allocative effects of taxation over the period. However, we can draw some qualitative conclusions about the relationship between tax policy and economic development as follows.

For taxation to yield a sufficient amount of revenue to finance the provision of public services and transfer payments, the tax system needs to be elastic and buoyant with respect to income growth. Buoyancy is a measure of total responsiveness due to both discretionary and automatic changes in the revenue system. Elasticity is a measure of automatic response of revenue to economic growth after removing the effects of discretionary measures.

The tax buoyancy has risen over the period, from 1.19 between 1980-1986 to 1.29 between 1987-1992. The tax/GDP ratio also rose significantly from 12.5 per cent in 1980 to 17.1 per cent in 1992. The improvements in these measures were due to tax reforms in such areas as in broadening the income tax base, the phasing out of unnecessary tax preferences and tax incentives, and the increasing reliance on ad valorem rate in the case of excise taxes and customs duties, the removal of the business tax and the introduction of the value added tax. The increased tax buoyancy and tax ratio enabled the government more flexibility on the expenditure side in carrying out its allocative and distributional functions.

Thailand succeeded in becoming a major exporter of manufactured products. Manufactures exports increased at 30 per cent annually toward the end of the 1980s despite a slowdown in the world economy. Tax policy has played an important role in this respect. Rationalization of the customs tariff structure toward more uniformity and lower effective protection, though not yet fully realized, has helped remove biases against exports. The existence of various export tax refund schemes including duty drawback, tax rebate, and facilities in export processing zones and bonded manufacturing warehouses, have relieved much of the burden of indirect taxation on non-traditional exports. These are the only measures that could be applied under the previous regime of high and cascading taxes. Anything more by way of incentives, if explicitly granted, could have been perceived as a subsidy under GATT rules. The introduction of VAT especially favours exports in many respects. The tax credit mechanism removes the cascading elements, embodied in taxes on raw materials and capital goods of the previous tax regime. The zero-rating of exports implied that exported goods from Thailand are completely tax-free, and therefore Thai exporters can compete more effectively in the world market. Finally, these features are more transparent and in line with the GATT principles.

There were many features in the Thai tax system that contributed toward the unprecedented surge in investment toward the end of the 1980s. Increasing revenue buoyancy greatly enhanced the capacity of the Government to undertake higher levels of expenditure on social and economic infrastructure that were needed to support expansion of private investment. Corporate investors in Thailand face very low marginal effective rates of taxation, which are due to low personal and corporate income tax rates, the protection of dividend income against double taxation, reasonable provisions for depreciation allowances and inventory valuation, and

a variety of exemptions granted by the Board of Investment (BOI). All the features favouring exports mentioned above also have positive effects on investment. Particularly the adoption of a consumption-type VAT allows full and immediate credits for capital goods. This is better than the previous BOI exemption of business tax since it does not interfere with market forces.

The above factors have undoubtedly contributed to the rapid growth of the economy. It must be realized that growth is a much wider phenomenon and various economic policies can have effects on growth prospects. Tax reform alone might have only a limited impact on the growth of the economy. All tax policies that affect export promotion and investment expansion however also affect the country's economic growth.

Tax Policy and equity

There seems to be relatively little agreement among empirical studies on the direction of change in the income distribution in Thailand. Certain studies have pointed to the worsening of inequality as measured by the GINI coefficient, especially in recent years. A recent survey by the National Statistical Office indicates that there has been a rising trend in income inquality among income classes, regions, between rural and urban areas, and between occupations. However, most studies have agreed that there has been a significant success in reducing poverty. A recent World Bank study[1] concluded that the high performing Asian economies, including Thailand, have achieved unusually low and declining levels of inequality, contrary to historical experience and contemporary evidence in other regions. Given rapid growth and declining inequalities, these economies have been successful in reducing poverty. Between 1962-1986, the percentage of population below the poverty line in Thailand less than halved, from 59 to 26 per cent.

Tax policy is one area of economic policies traditionally believed to have certain impact on income distribution and poverty. However, existing empirical evidence has suggested that the current tax policies of most developing countries apparently do not affect the prevailing income distribution to a significant extent.[2] The reason is relatively simple: developing economies have been unable to levy successfully the direct taxes needed to introduce marked progressivity into the revenue system; such taxes are generally insignificant in the revenue structures of most developing countries. Indirect taxes, on the other hand, are significant in the revenue structures of developing countries but are known to be regressive. On the whole, therefore, the tax systems in developing countries have been found to reduce income inequalities only marginally, if at all.[3]

Thailand is no exception in this respect. The basic structure of taxation did not change radically up to 1986; the reform process only accelerated after 1990. Therefore, it is unrealistic to expect that these tax reform programmes would have significant effects on income distribution. Moreover, most tax measures take time to become effective, further reducing the redistributive power of tax changes in the short run. The following is a survey of the possible redistributional effects of measures by types of tax and including improvements in tax administration in Thailand.

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[1] The East Asian Miracle, *Economic Growth and Public Policy* (The World Bank, 1993).

[2] R. Ram, "Population increase, economic growth, educational inequality, and income distribution: Some recent evidence", *Journal of Development Economics*, vol. 14 (April 1984).

[3] Richard M. Bird and lue H. Re Wilf, "Taxation and income distribution in Latin America: A critical review of empirical studies", *IMF Staff Papers*, vol. 20 (November 1993).

Administrative improvements

Improved tax administration, especially of personal and corporate income taxes, could be one of the best ways to improve equity. Over the period since 1980, there have been significant administrative improvements in the Revenue, Excise and Customs Departments. The most important improvement has been the computerization of tax collection in all the three departments. This has been of great help in speeding up of the processing of tax returns, assessment of tax liabilities, management and collection of tax arrears, enforcement and suppression of tax evasion, and providing a reliable information system for management. The Revenue Department, which is responsible for the collection of income taxes, has been reorganized along functional lines, with delegation of authorities to regional and district offices to enhance taxpayer services and efficiency in tax collection. With the introduction of VAT, it is expected that the efficiency in collection will improve considerably through an increase in the number of taxpayers and the harmonization of tax information systems.

Personal income tax

The personal income tax is traditionally considered to be the main progressive element in a country's tax structure. Several arguments, however, suggest that this role is exaggerated, particularly in developing countries. The existence of substantial tax evasion reduces its effective progressivity. Schedular income taxation, which taxes incomes from different sources separately and often differently, has adverse distributional implications compared with a global income tax system in which pooled income is taxed. The lack of effectiveness of tax administration also plays an important role in determining the ultimate burden of the personal income tax.

Recognizing these limitations, there has been less emphasis on the progressivity of the personal income tax in Thailand. The tax rate structure, which used to be steeply graduated by law, has now been streamlined toward fewer income brackets and lower marginal tax rates. On the other hand, more attention is being given to horizontal equity, with more and more measures directed toward simplification and base broadening.

Corporate income tax

There is relatively little agreement on the incidence of the corporate income tax and no definitive statement can be made regarding its distributive impact. Given the assumption that the tax primarily falls on capital owners, it could be said that the corporate income tax would not be regressive. But, in practice, the corporate income tax is often levied efficiently only on a few large firms and is subject to erosion through generous provisions to encourage investments and exports.

The corporate income tax in Thailand is relatively simple and revenue productive. It also has many features that are highly conducive to corporate investments, such as the accelerated depreciation allowances. The major change in recent years has been the move toward one single tax rate applicable to all corporate profits, thereby enhancing the horizontal equity among corporate taxpayers.

Property tax

Property taxes have played only a marginal role in Thailand. But they have the potential to become an important source of revenue, especially for local government finance, and also to be a powerful instrument of distributional policy.

The distributional implications of property tax reform should be assessed in the context of decentralization of administrative power to local government. In Thailand, as in many other developing countries, the system of Government is very highly centralized, with little participation from people at the grass roots level. Local government bodies, in carrying out their administration, have to rely to a large extent on central government assistance, since their revenue is severely constrained by poorly designed and administered local taxes. Property taxes, which can potentially be a major revenue resource of local government, are, at present, underutilized. The reform of property taxes will strengthen local fiscal management and enhance the ability of local government bodies in providing public services and infrastructure for the well-being of their populace. This will take time, but the property tax reform will certainly improve the distribution of the fruits of economic development toward the various regions of the country.

General sales taxes

Broad-based consumption taxes in developing countries take a variety of forms. But the general consensus is that their burden is regressive, primarily because consumption forms a larger proportion of the income of lower-income groups. As a result, a uniform rate sales tax becomes a larger burden on the lower-income than on the upper income households. Fully aware of this fact, the authorities, in designing the VAT structure, have instituted many provisions that would relieve the low-income groups of the VAT burden. First, agricultural produce, including food and farm products, are exempted from VAT. Inputs used by farmers, such as fertilizers and pesticides, are also tax free. Second, in contrast to the previous business tax system, agricultural products are no longer subject to export taxes, but are zero-rated in the same fashion as other exports, thereby increasing real income to farmers. Third, an exemption threshold is fixed at a relatively high level, thereby excluding many small firms from the tax net. Finally, the VAT structure itself has many features that support equity, such as the comprehensive tax base, the cross checking of input and output taxes, and less scope for tax evasion.

Selective sales taxes

Sales taxes selectively imposed on certain goods and services can be designed to effect certain progressivity in tax burden distribution. In Thailand, the scope of excise taxes has been expanded, following the introduction of the single rate VAT. At present, a number of goods and services of a luxury nature have been added to the list of excisable items.

Import duties

In respect of equity, import duties tend to be much like sales taxes and often do not have a significant positive redistributive impact. Also, if appropriately structured, import duties are not supposed to serve the distributional objective, but rather they should serve as an instrument of industrial policy. In line with this, successful industrial policy would, over the long run, help improve the real income of the population.

There is no mention of distributional objective in the restructuring of customs duties in Thailand. Rather the reform of the import tariff structure has been directed toward more uniformity in tax rates and lowering the levels of effective protection, with the ultimate objective of improving production efficiency, lowering of the cost of production and raising international competitiveness of Thailand. The reform along this line is likely to reduce the

excess profit or economic rent enjoyed by formerly highly protected local producers, in favour of consumers in terms of lower prices. In addition, the biases against exports, which earlier existed, will be reduced, helping exporters compete more effectively in world markets and raise their real incomes, particularly those of agricultural exporters. As a result, the distribution of income should improve in the long run.

IV. CONCLUSIONS

Even though tax reform in Thailand started as early as the early 1980s in response to the economic difficulties caused by the oil shocks, the real progress and momentum of reform only intensified after 1990. It is, therefore, too early to judge the success of the reform programmes. One can however claim that they have moved in the right direction, given the fundamental changes in the world economy and in Thailand. Thus tax reform in Thailand did not happen in isolation, but rather in response to the changing situations over the period.

The changing world economic situation had an important bearing on the needs for a tax restructuring in Thailand. World trade and investment expanded as never before, with competition in world markets becoming more intensified. The Uruguay Round of GATT negotiations concluded in 1993 ushering in the prospect of a comprehensive liberalization in international trade in goods, services, and movements of factors of production. The proliferation of regional economic groupings, such as the European Single Market, NAFTA and AFTA, also contributed to the intensified competition. These required a fundamental reorientation of Thai economic policies, including tax policy, from previously inward looking toward more liberal, open, outward oriented policies.

The Thai economy had also gone through many important structural changes prior to the reform. The country had progressed rapidly from a backward agricultural economy to become a modern, middle income one, with a strong and diversified production base. In particular, toward the late 1980s the country enjoyed unprecedented growth in exports, investment and national output, and at the same time managed to maintain a satisfactory degree of financial stability. The markets for goods, services, factors of production and finances became more sophisticated and largely integrated with world markets. This period also saw the government fiscal position improving significantly as a result of very buoyant tax revenue. All these factors called for and created an environment favourable to tax reforms.

The policy emphasis of tax reform was not on the direct redistributive aspect of taxation. Rather the equity objective was reflected as part of a broader concept of neutrality, which implied that tax policy should aim at raising revenue for the Government in a least distorting manner. Tax policy was regarded as a macroeconomic policy in the same way as monetary policy and exchange rate policy. As such, taxes were not meant to selectively influence particular economic units, sectors or industries. Instead, the design of a tax system should strive toward macroeconomic objectives, minimizing distortionary effects on the economy and creating an environment conducive to an efficient functioning of private markets. By doing so, horizontal equity would be achieved as individuals, businesses, factors of production, production processes and means of financing are treated equally by taxation. This, however, did not mean that vertical equity was not important. The progressivity objective of taxation was considered necessary and should be effected through the personal income tax. In fact, despite a series of downward changes in the levels of tax rates, the personal income tax rate

structure still remained progressive, with personal allowances maintained at sufficiently high levels so that low income individuals remained tax free.

The neutrality objective also had important implications for efficiency and international competitiveness. When tax-induced distortions and interferences were kept to the minimum, market forces could fully function with maximum efficiency. These distortions to economic efficiency, sometimes called deadweight loss, were often associated with a tax system with highly differentiated tax rates coupled with a wide range of tax preferences and incentives given to special interest groups, and a high degree of complexity that made taxpayer compliance very costly. The efficiency issue was also important for enhancing the competitive edge of Thai exports in the world market.

The introduction of VAT attempted to address this issue seriously. By eliminating the cascading effects of the previous business tax regime, the VAT could significantly improve the production efficiency without sacrificing government revenue. With a single tax rate, the VAT system was neutral with respect to resource allocation. Based on the destination principle of taxation, VAT also improved the country's competitiveness by zero-rating exports. Along the same line as VAT, the reform of import tariff, even though not yet completed, would move toward more uniformity and lower levels of tax rates, with an aim to increasing efficiency in industrial production. Both changes were also expected to contribute to further simplification of the tax system considerably, compared to the previous system that had multiplicity of tax rates and ambiguity in interpretation of the tax law. With regard to revenue productivity, it is too early be assess the effect of the reforms after 1990 on the buoyancy and elasticity of the tax system. But, it is likely that these will improve as the reforms have broadened the tax base and plugged the loopholes that existed in the previous tax regime. It is already evident that the reforms along this line implemented earlier had contributed to a significant rise in tax buoyancy and tax ratio toward the end of the 1980s to produce surpluses in the government budgets.

Given that much has already been done in recent years, one might be tempted to be complacent about past achievements. In fact, there remain difficult and challenging tasks ahead that await policy actions. Therefore, the momentum of tax reform that is already in place need to be kept alive and continued into the future.

The import tariff restructuring has been realigned only partially for some industrial sectors. The comprehensive, across-the-board reform needs to be implemented in due course, keeping in focus the movement toward more uniformity and the reduction of effective protection. It might be necessary to forego government revenue in the short run, but the shortfall in import duty revenue would be more than offset in the long run by greater revenue from income and domestic consumption taxes.

Finally, in accordance with government policy of decentralizing administrative power, it is now time for a major reform of the property tax structure. The move to enhance the revenue potential of property taxes would improve the distribution of income in at least two ways. First, the burden of property taxes is generally progressive and shared by taxpayers in line with the benefits received from government services. Second, the increased revenue capacity of localities, which are closest to their constituencies, would allow them to respond more flexibly to the needs of the local people.

Appendix. Summary of the tax system, 1994[a]

Tax	*Nature of tax*	*Exemptions and deductions*	*Rates*
I. CENTRAL GOVERNMENT			
1. Taxes on net income and profits			
1.1 *Taxes on companies* (Revenue Code Act of 1938, amended in 1991).	a. Companies, registered partnerships, and limited partnerships are taxed from sources within or without Thailand. Foreign companies, not registered or not residing in Thailand, are subject to tax only on income from sources within Thailand.	a. Taxable net profits are determined after business expenses and depreciation allowances, ranging from 5 to 20 per cent of original cost for most types of assets. Net losses may be carried forward to five consecutive years. No allowance for carrying back losses to previous years. Intercorporate dividends are exempted for 50 per cent of dividends received. For holding companies and companies listed in SET, dividends are completely exempted, provided the shares are held 3 months prior to and after the receipt of dividends.	a. Tax rate is 30 per cent on net profit.
	b. Companies incorporated abroad are also subject to a withholding tax on income from Thailand in the form of dividends, property rights, rentals, interest, and fees for certain services.	b. Withholding tax is calculated on gross income. Exemptions or reduced tax rates are provided for companies in a country which has the double tax treaty with Thailand.	b. Withholding tax is 15 per cent except on dividends which are taxes at 10 per cent.

[a] Updated February 1994.

Appendix *(continued)*

Tax	*Nature of tax*	*Exemptions and deductions*	*Rates*
	c. Foreign companies carrying on international transport.		c. 3 per cent of fares, fees and other income for passenger transport; 3 per cent of freight fees, and other income for freight transport.
	d. Non-profit foundations and associations.		d. A tax of 10 per cent is levied on gross revenue before deduction of any expenses. The computation of gross revenue does not include registration or subscription fees or any money or property received by way of donation or gift.
1.2 *Tax on individuals* (Revenue Code Act of 1938, amended in 1973).	Individual (and ordinary partnerships) residing for 180 days or more in Thailand in any calendar year are subject to tax on income derived from sources within or without Thailand. Non-resident persons are subject to tax only on income derived from sources within Thailand. Incomes from different sources are taxed differently.	The following types of income are exempted: superannuation and insurance policies; gifts and income from bequests; proceeds from sales of movable property acquired through inheritance or for a purpose other than profit; income received from companies operating under the Promotion of Investment Act; prizes, awards, and lottery winnings; workers' compensation, insurance claims, medical benefits; income from rice farming; profits received from business already subject to individual income tax. Also, income of non-residents, residing in the country which has a double taxation treaty with Thailand is exempted or subject to reduced tax rates.	

Appendix *(continued)*

Tax	*Nature of tax*	*Exemptions and deductions*	*Rates*
	Tax on employment and business income is imposed at progressive rates on net income (after deductions and allowances). But it cannot be less than the minimum tax on gross income.	Taxable net income is determined after the following deductions from gross income: standard deduction of 40 per cent of gross income not in excess of B 60,000 from earned income (from employment or services rendered and copyright); standard deduction ranging from 10 to 30 per cent of gross income (depending on the type of asset rented) or actual expenses, from rental income; standard deduction of 30 to 60 per cent of gross income, or actual expenses, from income from liberal professions; and standard deduction ranging from 40 to 85 per cent of gross income (depending on type of business activity), or actual expenses, from all other business income (industrial, agricultural, and construction activities). In addition, the following allowances are permitted: personal allowances of B 30,000 for taxpayer, B 30,000 for spouse, B 15, 000 for each child, B 2,000 for the education of each child (not exceeding 3 children); B 30,000 for an estate that is property of the taxpayer, and B 30,000 for each member of ordinary partnership, totalling not	**Net income bracket** — **Tax rate** Up to B 100,000 — 5 per cent B 100,001 – B 500,000 — 10 per cent B 500,001 – B 1,000,000 — 20 per cent B 1,000,001 – B 4,000,000 — 30 per cent over B 4,000,000 — 37 per cent **Gross income (for minimum tax)** B 60,000 or more — 0.5 per cent **Tax credit** Dividends or share of profits received from domestic companies are entitled to a tax credit at a rate of three-seventh of the amount received.

Appendix *(continued)*

Tax	*Nature of tax*	*Exemptions and deductions*	*Rates*
		more than B 60,000; an allowance of up to B 10,000 for life insurance company operating in Thailand for at least ten years, with respect to the life insurance policy of the taxpayer and his spouse; up to B 10,000 for contributions to approved provident funds; and actual contribution to social insurance fund and up to B 10,000 for interest paid on mortgage loans for housing; and allowance for the amount of charitable contributions up to 10 per cent of the remaining taxable income after deductions of all preceding allowances.	
	Tax on interest income	Exemptions are given on: a. Demand deposits with Government Saving Bank and savings deposits with cooperatives and the Bank for Agriculture and Agricultural Cooperatives. b. Saving deposit with any banks in Thailand not exceeding 10,000 baht.	Withholding tax at a rate of 15 per cent.
	Tax on dividends or share of profits received from domestic companies and mutual funds when the income earner does not claim a tax refund of tax credit.		Final withholding tax at the rate of 10 per cent.
	Tax on income from sale or		Final withholding tax of a graduated rate

Appendix *(continued)*

Tax	*Nature of tax*	*Exemptions and deductions*	*Rates*
	transfer of immovable property, other than exempt.		structure with a maximum of 20 per cent of sale price after deductions granted in accordance with the nature of the transfer and years of ownership.
2. Social security contributions			
None			
3. Employers' payroll or manpower taxes			
None			
4. Taxes on property			
4.1 *Real estate transfer tax* (Land Code Act of 1954, amended in 1973)	Transfer (whether by sale, gift, or succession at death) of real estate is taxed on the basis of the assessed value of the property.		2 per cent of the assessed value; 0.5 per cent if the transfer is made to parents, spouses, or children.
5. Taxes on goods and services			
5.1 *Value added tax* (Revenue Code Act of 1938, amended in 1991)	VAT replaced business tax on 1 January 1992. All goods and services are subject to VAT.	Exemptions include: – Business with annual turnover not more than 600,000 baht – Agricultural products and related inputs e.g. fertilizer, animal feed, medicine and chemicals – Newspaper, magazine, textbook – Education – Arts and crafts – Medical practices, auditing, legal practices and other professional services	– General rate: 7 per cent – For business with annual turnover of 600,000-1,200,000 baht, the business operator has a choice between a gross turnover tax at a rate of 1.5 per cent or the normal VAT. – For export: 0 per cent

Appendix *(continued)*

Tax	*Nature of tax*	*Exemptions and deductions*	*Rates*
		– Hospitals – Research or technical services – Library, museum, zoo – Labour contract – Sports (non-professional) – Acting, performance – Domestic transport – International land transport (air and sea transport is under the reciprocal treatment between the countries) – etc.	
5.2 *Specific business tax*	Specific business tax is inposed in lieu of VAT on following business: – Commercial banks – Finance firms and credit fonciers – Insurance companies – Pawn shops – Other business with similar operations as commercial banking – Sales of non-moveable properties – Stock exchange – Others as decreed	Following business are exempted: – BOT, GSB, GHB, BAAC – IFCT – Saving cooperatives – Provident fund – NHA – Others as decreed (e.g. stock exchange)	– Banking and financial institutions – interest 3 per cent earning – profit 3 per cent – Insurance – interest 2.5 per cent – premiums 3 per cent – Pawnshop 2.5 per cent – Sales of properties 3 per cent – Sale of stocks and shares 0.1 per cent (currently exempted)
5.3 *Selective excises on goods*	Excises are levied on selected locally produced and imported goods	Diplomatic saler and sales of fuel to ships and international airlines are	Typical rate

Appendix *(continued)*

Tax	*Nature of tax*	*Exemptions and deductions*	*Rates*
	(Liquor Act of 1991, Tobacco Act of 1991, Playing Cards Act of 1991, and Excise Tax Act of 1991).	petroleum products, cigarettes, alcoholic beverages, non-alcoholic beverages, playing cards, electrical appliances, automobiles, crystal wares, yacht, cosmetics and race course. The value of domestic goods is based on ex-factory price plus excise duty but sometime the value is based on the price which Director General has published in the Royal gazette from time to time. In case of imported goods the value is based on c.i.f. plus import duty and excise duty.	exempted. Tax is refunded when an excisable item is exported.	Most excisable goods are subject to specific or ad valorem rates, whichever is higher. 1. Petroleum and petroleum product 1.1 Gasoline and similar fuel (a) Gasoline (lead content more than 0.15 g/l) 36 per cent or 3.35 B/litre (b) Gasoline (lead content not more than 0.5 g/l) 32 per cent or 3.05 B/litre (c) Unleaded gasoline 25 per cent or 2.35 B/litre 1.2 Kerosene 23 per cent or 3.00 B/litre 1.3 Fuel for jet air craft 1 per cent or 0.20 B/litre 1.4 Diesel and similar fuel (a) Diesel (sulphur content more than 0.5 per cent) 25 per cent or 2.10 B/litre (b) Diesel (sulphur content not more than 0.5 per cent) 26 per cent or 2.00 B/litre 1.5 Fuel oil 17 per cent 1.6 LPG 23 per cent or 2.17 B/kg 1.7 Natural gas liquid 36 per cent or 3.15 B/litre

Appendix *(continued)*

Tax	*Nature of tax*	*Exemptions and deductions*	*Rates*
			2. Spirits 2.1 Fermented spirits – Beer (100 degree) 48 per cent or 100 B/litre – Other beer (100 degree) 20 per cent or 100 B/litre 2.2 Distilled spirits – Whiskey (100 degree) 24 per cent or 100 B/litre – Brandy (100 degree) 20 per cent or 100 B/litre – Other whiskey and brandy (100 degree) 28 per cent or 100 B/litre – Samtub (100 degree) 10 per cent or 6 B/litre – Samtub which have been transformed or used for medical scientific 0.05 B/litre 3. Tobacco 3.1 Shredded tobacco 0.01 B/10 gm 3.2 Tobacco – Cigars 0.1 per cent or 0.12 B/gm – Cigarettes 60 per cent

Appendix *(continued)*

Tax	*Nature of tax*	*Exemptions and deductions*	*Rates*
			– Others 0.1 per cent or 0.02 B/gm – Blended shredded 0.01 per cent or 0.09 B/gm – Chewing tobacco 0.1 per cent or 0.09 B/gm
			4. Beverages – Soda water 25 per cent or 0.77 B/440 cc – Soft drink 18 per cent or 0.45 B/440 cc – Juice 4 per cent or 0.20 B/440 cc
			5. Playing cards 30 B/100 cards
			6. Electrical appliances – Air conditioners 14 per cent – Chandeliers 2 per cent
			7. Automobiles – Under 2,400 cc 32.5 per cent – Over 2,400 cc 38 per cent
			8. Crystal 2 per cent

Appendix *(continued)*

Tax	*Nature of tax*	*Exemptions and deductions*	*Rates*
			9. Yacht 5 per cent 10. Cosmetics 12 per cent 11. Race course 13 per cent
5.4 *Profits of fiscal monopolies*	Central Government is recipient of the profits of the following fiscal monopolies; the Thai Tobacco Monopoly, the State Lottery, and the production of playing cards by the Excise Department.	None	Rates are negotiated between the Ministry of Finance and individual monopolies.
6. Taxes on international trade and transaction			
6.1 *Import duties* (Customs Tariff Act of 1935, amended in 1987).	Ad valorem (on c.i.f. value) and or specific duties are imposed on imports, classified according to the harmonized system. In addition, special duties are levied on certain commodities, and surcharges on imports competing with the output of promoted firms.	Exemption is granted to personnel of United Nations organizations and of accredited diplomatic missions. Companies operating under the Promotion of Investment Act are exempted on machinery, parts, accessories, and items to be re-exported. Also, they are granted reduction of up to 90 per cent of the duty on raw materials for not more than one year. Re-exports of goods that have been imported within the preceding two years and have not undergone change in character or from are exempted. Companies operating under the	The current tariff structure is undergoing a reform aiming to lower tariff barriers and reduce numbet of rates to 6 basic rates and 2 special rates as follows: – Special policy goods 0 per cent – Raw material 1 per cent – Primary goods and machinery 5 per cent – Intermediate goods 10 per cent – Finisged goods 20 per cent – Highly protected goods 30 per cent – Passenger cars capacity not exceeding 2,400 cc 42 per cent

Appendix *(continued)*

Tax	*Nature of tax*	*Exemptions and deductions*	*Rates*
		Petroleum Act, and Industrial Authority of Thailand Act (bonded warehouses and export processing zones) are exempted. Crude oil, fertilizers, fish and fish products, jewelry, munitions of war, are zero rated. Duties on inputs used in the production of exports are refunded.	– Passenger cars capacity exceeding 2,400 cc 68.5 per cent
6.2 *Export taxes* (CustomsTariff Act of 1935 amended in 1987).			
6.2.1 Export taxes	Ad valorem or specific duties are imposed on exports of the following items: rice, metal scrap, hides (tanned, raw) rubber, wood, wood articles, raw silk and fish (unfit for human consumption).	Because of exporting promotion, most of export taxes are exempted, except rawhides, wood and raw silk.	– Rawhides: 5 B/kg – Wood: 40 per cent – Raw silk: 100 B/kg – Wood 3.40 per kg – Raw silk B 100/kg
7. Other taxes			
7.1 *Stamp duties* (Revenue Code Act of 1938, amended in 1973).	Stamp duties are imporsed on documents (government forms, legal contracts, and other instruments), on an ad valorem basis or per transaction.		Rates range from B 1.0 per B 1,000 (on lease of property, contractor's services, insurance policy, transfer of securities, arbitrator' award) to B 100 (on articles of association of a limited company).
II. LOCAL GOVERNMENTS: PROVINCES (changwats) municipalities (tesabans) and sanitary districts (sukhapibans). (Municipal Income Act of 1954, Sukhapiban Revenue Act of 1955, and Royal Decree on Changwat Income of 1956).			

Appendix *(continued)*

Tax	*Nature of tax*	*Exemptions and deductions*	*Rates*
1. Taxes on net income and profits			
None			
2. Social security contributions			
None			
3. Employers' payroll or manpower taxes			
None			
4. Taxes on property			
4.1 *Real estate taxes*			
4.1.1 *House and rent tax* (House and Land tax Act of 1932).	The house and rent tax is levied annually on buildings rented or used for other commercial purposes. The tax is allocated to all levels of local government.	Owner-occupied dwellings are exempted. Also exempted are buildings used by government agencies, public hospitals, schools, State Railway of Thailand and religious organizations.	12.5 per cent of the annual rental value.
4.1.2 *Land development tax* (Land Development Act of 1965).	The land development tax is levied annually on the value of unimproved land not subject to the house and rent tax. The tax is allocated to all levels of local governments.	Land occupied by owner or used for annual crops is fully or partially exempted. A person who owns land in several provinces is allowed exemption only on land in one province, although his land holdings are travel separately in each province. Land owned by government agencies, public hospitals, schools, public utilities, and religious organizations are also exempted.	34 different rates ranging from B 0.50 per rai with an assessed value of under B 200 to B 70 per rai with an assessed value of over B 10,000 and B 25 per rai for each additional B 10,000 (One rai is equivalent to 0.16 hectare).

Appendix *(continued)*

Tax	*Nature of tax*	*Exemptions and deductions*	*Rates*
5. Taxes on goods and services			
5.1 *VAT surcharge*	Surcharge on the VAT imposed by the Central Government (see 5.1). The surcharge is collected by the Revenue Department and allocated to all levels of local government.		10 per cent of the VAT is VAT rate of 7 per cent is inclusive of the local surcharge of 0.7 per cent.
5.2 *Surcharge on selected excises*			
(1) Alcoholic and non-alcoholic beverages	Surcharge on selected excises imposed by the Central Government (see 5.3). The surcharge is collected by the Excise Department and allocated to local governments.		10 per cent of excise tax.
(2) Petroleum and petroleum products			
(3) Electrical appliances			
(4) Crystals			
(5) Automobiles			
(6) Yachts			
(7) Horse racing courses			
5.3 *Profits of fiscal monopolies*			
None			

Appendix *(continued)*

Tax	*Nature of tax*	*Exemptions and deductions*	*Rates*
5.4 *Taxes on specific services*			
None			
5.5 *Taxes on use of goods and property, and permission to perform activities*			
5.5.1 *Licenses and fees*	Slaughtering, posting signboards, and various other activities, are subject to taxes and license fees, which are allocated to all levels of local government.		Multiple
5.5.2 *Motor vehicle registration fee* (Motor Vehicle Act of 1979, Inland Transport Act of 1979).	Motor vehicles (passenger cars, motorcycles and special vehicles; buses and trucks) are subject to an annual registration fee. The fee is collected by the Central Government (Inland Transport Department) and allocated to local government in the following proportions: 25 per cent to provinces; 50 per cent to municipalities; and 25 per cent to sanitary districts.	Automobiles belonging to government departments and local authorities are exempted. Tractors used in agriculture, ambulances and automobiles belonging to Red Cross are also exempted.	For passenger cars carrying 7 passengers or less, the fee is based on cylinder capacity: B 0.50 per cc for portion of the cylinder capacity under 600 cc. B 1.50 per cc for the portion between 600 cc–1,800 cc. B 4 per cc for the portion over 1,800 cc. For passenger cars carrying more than 7 passengers, the fee is based on weight ranging from B 150 to B 3,600. For motorcycle, the fee is B 100 per unit. For passenger cars registered for more than 5 years, the fee is reduced at a rate of 10 per cent increments per year, e.g. 10 per cent reduction is given on the 6th year, 20 per cent reduction on the 7th year to 50 per cent reduction after the 9th year.

Source: Ministry of Finance, Fiscal Policy Office, Bangkok.